

**FEDERAL RESERVE SYSTEM****12 CFR Part 217 and 252**

[Docket No. R-1673]

RIN 7100-AF 56

**Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities****AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) is inviting comment on a proposal to establish risk-based capital requirements for depository institution holding companies that are significantly engaged in insurance activities. The Board is proposing a risk-based capital framework, termed the Building Block Approach, that adjusts and aggregates existing legal entity capital requirements to determine an enterprise-wide capital requirement, together with a risk-based capital requirement excluding insurance activities, in compliance with section 171 of the Dodd-Frank Act. The Board is additionally proposing to apply a buffer to limit an insurance depository institution holding company's capital distributions and discretionary bonus payments if it does not hold sufficient capital relative to enterprise-wide risk, including risk from insurance activities. The proposal would also revise reporting requirements for depository institution holding companies significantly engaged in insurance activities.

**DATES:** Comments must be received on or before December 23, 2019.**ADDRESSES:** You may submit comments, identified by Docket No. R-1673 and RIN 7100-AF 56, by any of the following methods:

- **Agency website:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- **Email:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

- **Fax:** (202) 452-3819 or (202) 452-3102.

- **Mail:** Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW, Washington, DC 20551.

All public comments are available from the Board's website at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons or to remove sensitive personal identifying information at the commenter's request. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room 146, 1709 New York Avenue NW, Washington, DC 20006, between 9:00 a.m. and 5:00 p.m. on weekdays.

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## I. Introduction

The Board of Governors of the Federal Reserve System (Board) is issuing this notice of proposed rulemaking (NPR) to seek comment on a proposal to establish risk-based capital requirements for certain depository institution holding companies significantly engaged in insurance activities (insurance depository institution holding companies).<sup>1</sup> As discussed in further detail in the description of the proposal, insurance depository institution holding companies include depository institution holding companies that are insurance underwriters, and depository institution holding companies that hold a significant percentage of total assets in insurance underwriting subsidiaries. The proposal introduces an enterprise-wide risk-based capital framework, termed the “building block” approach (BBA), that incorporates legal entity capital requirements such as the requirements prescribed by state insurance regulators, taking into account differences between the business of insurance and banking. The Board proposes to establish an enterprise-wide capital requirement for insurance depository institution holding companies based on the BBA framework, and, separately, to apply a minimum risk-based capital requirement to the enterprise using the flexibility afforded under recent amendments to section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to exclude certain state and foreign regulated insurance operations.<sup>2</sup> The Board is also proposing to apply a buffer that limits an insurance depository institution holding company's capital distributions and discretionary bonus payments if it does not hold sufficient capital relative to enterprise-wide risk, including risk from insurance activities. The minimum risk-based capital

<sup>1</sup> In this Supplementary Information, the term “insurance depository institution holding company” means a savings and loan holding company significantly engaged in insurance activities. Section IV.B below discusses the threshold proposed to determine when a depository institution holding company is significantly engaged in insurance activities. Although the approach described in this proposal was designed to be appropriate for bank holding companies that are significantly engaged in insurance activities, the Board does not propose to apply this rule to bank holding companies at this time. The Board's portfolio of depository institution holding companies that are significantly engaged in insurance activities is currently composed only of savings and loan holding companies. The Board intends to address the application of this approach to bank holding companies in the final rule.

<sup>2</sup> Public Law 111–203, 124 Stat. 1376, 1435–38 (2010), as amended by Public Law 113–279, 128 Stat. 3107 (2014).

requirement is proposed pursuant to the Board's authority under section 10 of the Home Owners' Loan Act (HOLA)<sup>3</sup> and section 171 of the Dodd-Frank Act.<sup>4</sup>

## II. Background

### A. The Dodd-Frank Act and Capital Requirements for Insurance Depository Institution Holding Companies

In response to the 2007–09 financial crisis, Congress enacted the Dodd-Frank Act, which, among other objectives, was enacted to ensure fair and appropriate supervision of depository institutions without regard to the size or type of charter and streamline the supervision of depository institutions (DIs) and their holding companies. In furtherance of these objectives, Title III of the Dodd-Frank Act expanded the Board's supervisory role beyond bank holding companies (BHCs) by transferring to the Board all supervisory functions related to savings and loan holding companies (SLHCs) and their non-depository subsidiaries. As a result, the Board became the federal supervisory authority for all DI holding companies, including insurance depository institution holding companies.<sup>5</sup> Concurrent with the expansion of the Board's supervisory role, section 616 of the Dodd-Frank Act amended HOLA to provide the Board express authority to adopt regulations or orders that set capital requirements for SLHCs.<sup>6</sup>

Any capital requirements the Board may establish for SLHCs are subject to minimum standards under the Dodd-Frank Act. Specifically, section 171 of the Dodd-Frank Act requires the Board to establish minimum risk-based and leverage capital requirements on a consolidated basis for depository institution holding companies.<sup>7</sup> These

<sup>3</sup> 12 U.S.C. 1467a.

<sup>4</sup> 12 U.S.C. 5371.

<sup>5</sup> Public Law 111–203, title III, 301, 124 Stat. 1520 (2010).

<sup>6</sup> Dodd-Frank Act Sec. 616(b); HOLA Sec. 10(g)(1). Under Title I of the Dodd-Frank Act, the Board also supervises any nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Board. Under section 113 of the Dodd-Frank Act, the FSOC may designate a nonbank financial company, including an insurance company, to be supervised by the Board. Currently, no firms are subject to the Board's supervision pursuant to this provision.

<sup>7</sup> Section 171 of the Dodd-Frank Act defines “depository institution holding company” to mean a bank holding company or savings and loan holding company, each as defined in section 3 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1813. As mentioned above, the population of insurance depository institution holding companies only consists of SLHCs. In requiring minimum leverage capital requirements for depository institution holding companies, section 171 of the Dodd-Frank Act provides the Board with flexibility

requirements must be not less than the capital requirements established by the Federal banking agencies to apply to insured depository institutions (IDIs), nor quantitatively lower than the capital requirements that applied to IDIs when the Dodd-Frank Act was enacted. The Dodd-Frank Act sets a floor for any capital requirements established under section 171 that is based on the capital requirements established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action regulations implementing section 38 of the FDI Act.<sup>8</sup>

The Board issued a revised capital rule in 2013, which served to strengthen the capital requirements applicable to banking organizations supervised by the Board by improving both the quality and quantity of regulatory capital and increasing risk-sensitivity. In consideration of requirements of section 171 of the Dodd-Frank Act, in 2012, the Board had sought comment on the proposed application of the revised capital rule to all firms supervised by the Board that are subject to regulatory capital requirements, including all savings and loan holding companies significantly engaged in insurance activities. In response, the Board received comments by or on behalf of supervised firms engaged primarily in insurance activities that requested an exemption from the capital rule in order to recognize differences in their business model compared with those of more traditional banking organizations. After considering these comments, the Board determined to exclude insurance SLHCs from the application of the rule.<sup>9</sup> The Board committed to explore further whether and how the revised capital rule, hereinafter referred to as the “banking capital rule,” should be modified for insurance SLHCs in a manner consistent with section 171 of the Dodd-Frank Act and safety and soundness concerns.

Section 171 of the Dodd-Frank Act was amended in 2014 (2014 Amendment) to provide the Board flexibility when developing consolidated capital requirements for

insurance depository institution holding companies.<sup>10</sup> The 2014 Amendment permits the Board to exclude companies engaged in the business of insurance and regulated by a state insurance regulator, as well as certain companies engaged in the business of insurance and regulated by a foreign insurance regulator.

The 2014 Amendment to section 171 of the Dodd-Frank Act does not require the Board to exclude state-regulated, or certain foreign-regulated, insurers from its risk-based capital requirements. The Board has considered that exclusion of these insurers from the measurement and application of all risk-based capital requirements could present challenges to the Board’s ability to timely and accurately assess the risk profile and capital adequacy of the entire organization and fulfill the Board’s responsibility as a prudential supervisor of the organization. A more effective regulatory capital framework, reflecting the Board’s objectives as consolidated supervisor of insurance depository institution holding companies, would capture all risks that face the enterprise and potentially could jeopardize the organization’s ability to serve as a source of financial strength to the subsidiary IDI. There is support for taking this approach in both section 171 of the Dodd-Frank Act and section 10 of HOLA.

Section 171 of the Dodd-Frank Act also provides that the Board may not require, under its authority pursuant to section 171 of the Dodd-Frank Act or HOLA, financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) from a supervised firm that is also a state-regulated insurer and only files financial statements utilizing Statutory Accounting Principles (SAP).<sup>11</sup> The Board notes that, unlike U.S. GAAP, SAP does not include an accounting consolidation concept. As discussed in detail in subsequent sections of this notice, the BBA is thus an aggregation-based approach and the Board’s proposal is designed as a comprehensive approach to capturing risk, including all material risks, at the level of the entire enterprise or group.

#### *B. The 2016 Advanced Notice of Proposed Rulemaking on Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities*

On June 14, 2016, the Board published in the **Federal Register** an advance notice of proposed rulemaking

(ANPR) entitled “Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities.”<sup>12</sup> In the ANPR, the Board conceptually described the BBA as a capital framework, contemplated for insurance depository institution holding companies, based on aggregating available capital and capital requirements across the different legal entities in an insurance group to calculate these two amounts at the enterprise level.<sup>13</sup> The ANPR described a number of potential adjustments that could be applied in the BBA, including adjustments to address variations in accounting practices across jurisdictions in which insurers operate, double leverage, aggregation across different jurisdictional capital frameworks, and defining loss-absorbing capital resources.<sup>14</sup> In the ANPR, the Board asked questions on all aspects of the BBA, including key considerations in evaluating capital frameworks for insurance depository institution holding companies, whether the BBA was appropriate for these firms as well as advantages and disadvantages of this approach, and the adjustments contemplated for use in the BBA.<sup>15</sup>

Among other things, the ANPR provided stakeholders with an opportunity to comment on the Board’s development of a capital framework for insurance depository institution holding companies at an early stage. This NPR builds upon the discussion in the ANPR and reflects the Board’s review of comments submitted in response to the ANPR. The comments are generally addressed below.

<sup>12</sup> 81 FR 38631 (June 14, 2016).

<sup>13</sup> As used in this Supplementary Information, “available capital” refers to loss absorbing capital that qualifies for use as capital under a regulatory capital framework and “capital requirement” refers to a measurement of the loss absorbing resources the firm needs to maintain commensurate with its risks.

<sup>14</sup> As used in this Supplementary Information, “capital resources” refers to instruments and other capital elements that provide loss absorbency in times of stress.

<sup>15</sup> In the ANPR, the Board also described a framework that was contemplated for application to nonbank financial companies significantly engaged in insurance activities (systemically important insurance companies), the Consolidated Approach (CA). This framework, based on consolidated financial statement data prepared in accordance with U.S. GAAP, would categorize insurance liabilities, assets, and certain other exposures into risk segments, determine consolidated required capital by applying risk factors to the amounts in each segment, define available capital for the consolidated firm, and determine whether the firm has enough consolidated available capital relative to consolidated required capital. The Board appreciates the comments it has received regarding the CA. The Board continues to deliberate a capital requirement for systemically important insurance companies.

to develop leverage capital requirements that are tailored to the insurance business. The Board continues to consider a tailored approach to a leverage capital requirement for insurance depository institution holding companies.

<sup>8</sup> The floor for capital requirements established pursuant to section 171, referred to as the “generally applicable” requirements, is defined to include the regulatory capital components in the numerator of those capital requirements, the risk-weighted assets in the denominator of those capital requirements, and the required ratio of the numerator to the denominator.

<sup>9</sup> 12 CFR part 217 (Regulation Q).

<sup>10</sup> Public Law 113–279, 128 Stat. 3017 (2014).

<sup>11</sup> 12 U.S.C. 5371(c)(3)(A).

### C. General Comments on the ANPR

The Board received 27 public comments on the ANPR from interested parties including supervised insurance companies, insurers not supervised by the Board, insurance and other trade associations, regulatory and actuarial associations, and others. Generally, commenters supported the Board's proposed tailoring of a capital requirement that is insurance-centric and appreciated the transparency and early opportunity to provide comment. Commenters agreed that capital frameworks should capture all material companies and risks faced by insurers, reflect on- and off-balance sheet exposures, and build on existing capital frameworks where possible. According to commenters, the Board's capital framework also should be informed by its potential effects on asset allocation decisions of insurers, not unduly incentivizing or disincentivizing allocation to certain asset classes. Commenters generally supported the Board's proposal to efficiently use legal entity capital requirements within an appropriate capital framework for both insurance depository institution holding companies and those insurance firms designated by the FSOC as systemically important. Commenters further suggested that the BBA should be built on principles that include minimal adjustments to already-applicable capital frameworks, indifference as to structure of the supervised firm, comparability across capital frameworks to which the supervised firm's entities are subject, appropriately reflecting insurance and non-insurance frameworks, and transparency. Commenters observed that the BBA would align relatively well with regulators' treatment of capital at individual companies and, consequently, the ways that capital may not be fungible.

In the ANPR, the Board asked what capital requirement should be used for insurance companies, banking companies, and companies not subject to any company-level capital requirement, as used in the BBA. For insurance companies subject to the NAIC's risk-based capital (RBC) requirements, commenters generally supported the use of required capital at the Company Action Level (CAL) under the NAIC RBC framework, with some preferring the use of a greater threshold, often termed the "trend test" level.<sup>16</sup> In

commenters' views, a key advantage of the BBA is compatibility with existing legal entity capital requirements. The BBA was also viewed as being reasonably able to capture the risks of non-homogenous products across jurisdictions and varying legal and regulatory environments. Since it is an approach that builds on existing legal entity capital requirements, the BBA would absorb the impact of how those requirements treat the subject entities' products.

According to commenters, among the key disadvantages of the BBA would be that the framework must reconcile possibly divergent valuation and accounting practices. As an aggregated approach, the BBA may not align with the insurance depository institution holding company's own internal approach for risk assessment, which may be conducted on a consolidated basis. Commenters expressed varying views on whether the BBA would be prone to regulatory arbitrage, but many noted that this may not be a shortcoming of the BBA if capital movements are subject to restrictions. With regard to specific implementation issues, commenters noted, among other things, that the BBA may entail challenges in calibrating scalars (the mechanism used to bring divergent capital frameworks to a common basis), identifying scalars with a sufficient level of granularity, and addressing differences in global valuation practices. Furthermore, commenters noted that valuation bases for required capital may differ from valuation bases for available capital.

Some commenters raised concerns about implementation costs and, noting that the BBA as set out may tend to have relatively low impact in terms of costs to regulators and the industry, suggested implementing the BBA over a timeframe in the range of one to two years. Multiple commenters agreed that the BBA is expected to have minimal setup and ongoing maintenance and compliance costs. One commenter noted that since the BBA is a tailored approach that uses a firm's existing books and records without compromising supervisory objectives, the BBA's design is anticipated to aid in controlling the burden.

### D. Comments on Particular Aspects of the ANPR

#### 1. Threshold for Determining a Firm To Be Subject to the BBA

The Board sought comment on the criteria that should be used to determine which supervised firms would be subject to the BBA. Commenters generally did not disagree with the Board's proposal to apply the BBA to supervised firms with 25 percent or more of total consolidated assets attributable to insurance underwriting activities (other than assets associated with insurance underwriting for credit risk). One commenter suggested that insurance liabilities, rather than dedicated assets, should be considered the principal indicator of insurance activity. Some comments suggested that the Board should consider a depository institution holding company to be an insurance depository institution holding company subject to the BBA when either the ultimate parent of the enterprise is an operating insurance underwriting company, or, if this is not the case, by applying the 25 percent threshold suggested in the ANPR.

The Board's proposed threshold for treating a depository institution holding company as significantly engaged in insurance activities, and thus subject to the BBA, is set out in Section IV.B.

#### 2. Grouping of Companies in the BBA

A preliminary question in applying the BBA is whether and, if so, how, the individual companies under an insurance depository institution holding company should be grouped before they are aggregated.

Some comments advocated an approach of keeping all companies together under a common parent as far up in the organizational structure as possible. Other comments saw merit to grouping a subsidiary IDI distinctly from an insurance parent. A number of commenters voiced views on standards for materiality or immateriality in determining whether to include companies under an insurance depository institution holding company when applying the BBA. More generally, commenters voiced openness to deeming companies immaterial if they do not pose significant risk to the insurance depository institution holding company.

The Board's proposed approach to grouping companies in an insurance depository institution holding company's enterprise in applying the BBA is set out in Section IV.C.

<sup>16</sup> The "company action level" under state insurance RBC requirements is the amount of capital below which an insurer must submit a plan to its state insurance regulator demonstrating how the insurer will restore its capital adequacy. The

"trend test level" adds a margin above the company action level, reflecting the company's current and recent preceding years' results.

### 3. Treatment of Non-Insurance, Non-Banking Companies

In the ANPR, the Board suggested that subsidiaries not subject to capital requirements, such as some mid-tier holding companies, would be treated under the Board's banking capital rule. Commenters expressed concern that this treatment may not always be appropriate, depending on whether the subsidiary's activities are more closely aligned with insurance or banking activities in the enterprise. Commenters suggested that, where the subsidiary's activities are related to insurance operations, treating these companies under capital frameworks applicable to the operating insurance parent of such companies may be more appropriate.

The Board's proposed treatment of non-insurance, non-banking companies under the BBA is discussed further in Section IV.C.

### 4. Adjustments

Generally, commenters favored relatively few or modest adjustments to available capital and capital requirements under existing capital frameworks when applying the BBA. According to commenters, adjustments should be focused on addressing accounting mismatches or gaps or to eliminate double-counting. Among other things, commenters advocated adjustments to reverse intercompany transactions and ensure that adequate capital is held to reflect the risks in captive insurance companies. Specific proposed adjustments included, among others, addressing valuation differences, reversing intercompany loans and guarantees, and reversing the downstreaming of capital.

Numerous commenters advocated the use of adjustments to eliminate state permitted and prescribed accounting practices, essentially reverting insurers' accounting treatment to that prescribed by the NAIC. With regard to implementation burden, one commenter noted that it likely would not be unduly burdensome to obtain the data related to permitted and prescribed practices for purposes of applying an adjustment under the BBA.

In response to the ANPR's question on how the BBA should address intercompany transactions, commenters suggested that at least some adjustments for intercompany transactions would be necessary, with varying views on the types of transactions that should be addressed through adjustments. Commenters similarly expressed that assets and liabilities associated with intercompany transactions should not be charged twice for the risks they pose

and that intercompany transactions that result in shifting risk from one subsidiary to another should be reviewed.

Many commenters expressed views that unwinding of intercompany transactions should be limited to those needed to prevent double-counting of capital. According to comments, capital should be counted only once as available capital. In particular, commenters highlighted double-leverage, whereby an upstream company's debt proceeds are infused into a downstream subsidiary as equity, resulting in equity at the subsidiary level that is offset by the liability at the parent and, hence, capital-neutral at the enterprise-level.

The proposed treatment of adjustments in the BBA is addressed in Sections VI.B and VII.B.

### 5. Scalars

In the BBA, existing capital requirements would be scaled to a common basis, addressing, among other things, cross-jurisdictional differences. Commenters advocated a framework for the BBA that distinguished between jurisdictions with capital frameworks suitable to be used and subjected to scalars (scalar-compatible frameworks) versus those with capital frameworks that should neither be used nor scaled (non-scalar-compatible frameworks).

A number of commenters advocated that the distinction between scalar-compatible and non-scalar-compatible frameworks should rest on three attributes that the frameworks should possess: (1) Risk-sensitivity; (2) clear regulatory intervention triggers; and (3) transparency in areas such as reserving, capital requirements, and reporting of capital measures. For material companies in a non-scalar-compatible framework, commenters suggested that their data should be restated to a scalar-compatible framework and then scaled in the BBA.

Section V of this NPR explains the Board's approach to scaling in the BBA, including the methodology adopted to produce this scaling approach.

### 6. Available Capital

Generally, commenters suggested that available capital under the BBA should be closely aligned with available capital permitted under state insurance laws. In its ANPR, the Board asked whether the BBA should include more than one tier of capital.<sup>17</sup> Commenters generally did not favor assigning available capital in the BBA to multiple tiers, citing reasons including the desire to minimize

adjustments to existing capital requirements and audited financial statement data, simplicity in the BBA's design, and accounting standards' treatment of certain assets as non-admitted. Commenters further suggested that the Board can achieve its supervisory objectives with a BBA that includes a single, rather than more than one, tier of capital.

The Board's proposed approach to determining available capital under the BBA is set out in Section VII.

## III. The Proposal

### A. Overview of the BBA

The proposed BBA is an approach to a consolidated capital requirement that considers all material risks on an enterprise-wide basis by aggregating the capital positions of companies under an insurance holding company after expressing them in terms of a common capital framework.<sup>18</sup> The BBA constructs "building blocks"—or groupings of entities in the supervised firm—that are covered under the same capital framework. These building blocks are then used to calculate the combined, enterprise-level available capital and capital requirement. At the enterprise level, the ratio of the amount of available capital to capital requirement amount, termed the BBA ratio, is subject to a required minimum and buffer, with a proposed minimum of 250 percent and a proposed total buffer of 235 percent.<sup>19</sup>

In each building block, the BBA generally applies the capital framework for that block to the subsidiaries in that block. For instance, in a life insurance building block, subsidiaries within this block would be treated in the BBA the way they would be treated under life insurance capital requirements. In a

<sup>18</sup> To streamline implementation burden while reflecting all material risks, the proposed BBA uses the insurance risk-based capital framework promulgated by the National Association of Insurance Commissioners (NAIC) as the common capital framework. As used in this Supplementary Information, "capital position" refers to an expression of a firm's capitalization, typically expressed as a ratio of capital resources to a measurement of the firm's risk.

<sup>19</sup> The BBA, as proposed, would apply to insurance depository institution holding companies. Should the Board later decide that its supervisory objectives would be appropriately served by applying the BBA to other institutions, including a systemically important insurance company, the Board retains the right to subject such a firm to the BBA by order. In addition, the Board will continue to evaluate prudential standards applicable to insurance depository institution holding companies, including those that are triggered by minimum capital requirements. However, the Board does not propose to apply Board-run stress testing standards to insurance depository institution holding companies at this time.

<sup>17</sup> 81 FR 38631, 38635 (June 14, 2016).

depository institution building block, subsidiaries would be subject to Federal banking capital requirements. To address regulatory gaps and arbitrage risks, the BBA generally would apply banking capital requirements to material nonbank/non-insurance building blocks. Once the enterprise's entities are grouped into building blocks, and available capital and capital requirements are computed for each building block, the enterprise's capital position is produced by generally adding up the capital positions of each building block. The BBA is consistent with the Board's continuing emphasis on adopting tailored approaches to supervision and regulation in a manner that streamlines implementation burden.

The BBA framework was designed to produce a consolidated risk-based capital requirement that is not less stringent than the results derived from the Board's banking capital rule. To enable aggregation of available capital and capital requirements across different building blocks, the BBA proposes a mechanism (scaling) to translate a capital position under one capital framework to its equivalent in another capital framework.<sup>20</sup> At the enterprise level, the BBA applies a minimum risk-based capital requirement that leverages the minimum requirement from the Board's banking capital rule, expressed as its equivalent value in terms of the common capital framework. The minimum required capital ratio under the BBA begins with this equivalence value but includes a safety margin to provide a heightened degree of confidence that the BBA's requirement is not less than the generally applicable requirement. Thus, the BBA produces results that are not less stringent than the Board's banking capital rule.

In designing the BBA, the Board considered, among other things, the activities and risks of insurance institutions, existing legal entity capital requirements, input from interested parties, comments to the ANPR, and the requirements of federal law. The Board sought to develop the BBA to reflect risks across the entire firm in a manner that is as standardized as possible, rather than relying predominantly on a supervised firm's internal capital models. Furthermore, the BBA is built

on U.S. regulatory and valuation standards that are appropriate for the U.S. insurance industry.

Board staff also met with interested parties, including members of the NAIC, to solicit their views on the overall development of the BBA. Input from the NAIC and states has helped identify areas of commonality between the BBA and the Group Capital Calculation (GCC) that is under development by the NAIC, achieve consistency between those frameworks wherever possible, and minimize burden upon firms that may be subject to both frameworks, while remaining respectful of the various objectives of the relevant supervisory bodies and legal environments.

These considerations exist in the context of the Board's participation in the international insurance standard-setting process and development of the international Insurance Capital Standard (ICS), an approach the Board did not follow in designing the BBA. The ICS is being developed through the International Association of Insurance Supervisors (IAIS) as a consolidated group-wide prescribed capital requirement for internationally active insurance groups (IAIGs).<sup>21</sup> In participating in this process, the Board remains committed to advocating, collaboratively with the NAIC, state insurance regulators, and the Federal Insurance Office, positions that are appropriate for the United States. In particular, this includes advocacy for development of an aggregation method akin to the BBA, and the GCC being developed by the NAIC, that can be deemed an outcome-equivalent approach for implementation of the ICS. In 2017, the IAIS decided to release the ICS in two phases: A five-year monitoring phase beginning in 2020, during which the ICS would be reported on a confidential basis to group-wide supervisors (the Monitoring Period), followed by an implementation phase. The IAIS released a public consultation document on ICS Version 2.0 in 2018,<sup>22</sup> and is planning to release ICS Version 2.0, for use in the Monitoring Period, in 2019.<sup>23</sup>

<sup>21</sup> Standards produced through the IAIS are not binding upon the United States unless implemented locally in accordance with relevant laws.

<sup>22</sup> IAIS, *Risk-based Global Insurance Capital Standard Version 2.0: Public Consultation Document* (July 31, 2018), <https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard/file/76133/ics-version-20-public-consultation-document>.

<sup>23</sup> IAIS, *The IAIS Risk-based Global Insurance Capital Standard (ICS): Frequently Asked Questions on the Implementation of ICS Version 2.0* (January 26, 2018), <https://www.iaisweb.org/file/71580/implementation-of-ics-version-20-qanda>.

The purpose of the ICS Monitoring Period is to monitor the performance of the ICS over time. It is not intended to be used as supervisory mechanism to evaluate the capital adequacy of IAIGs. The ICS Monitoring Period is intended to provide a period of stability for the design and calibration of the ICS so that group-wide supervisors, with the support of supervisory colleges, may compare the ICS to existing group standards or those in development, assess whether material risks are captured and appropriately calculated, and report any difficulties encountered. Reporting during the Monitoring Period will include a reference ICS as well as additional reporting at the request of the group-wide supervisor.

The reference ICS is comprised of a market-adjusted valuation approach (MAV), which is a market-based balance sheet valuation approach similar to that used under the Solvency II framework, along with a standard method for determining capital requirements and common criteria for available capital. At the group-wide supervisor's request, ICS 2.0 will also include an alternative valuation approach, GAAP with Adjustments, that is based on local GAAP accounting rules and reporting with certain adjustments to produce results that are comparable to the reference ICS. In addition, supervisors may request information on internal models as an alternative approach for calculating risk weights. During the Monitoring Period, the IAIS will also continue with the collection of information and field-testing of the Aggregation Method.

The reference ICS may not be optimal for the Board's supervisory objectives, considering the risks and activities in the U.S. insurance market. In the United States, financial firms frequently serve a substantial role in facilitating their customers' long-term financial planning. Insurers in the United States meet consumers financial planning needs with life insurance and annuity products in addition to property/casualty products to protect personal and real property and limit liability. Insurers match life insurance and annuity long-duration products with a long-term investment strategy.

As proposed, the BBA would appropriately reflect, rather than unduly penalize, long-duration insurance liabilities in the United States. In the United States, an aggregation-based approach like the BBA could also strike a better balance between entity-level, and enterprise-wide, supervision of insurance firms.

*Question 1: The IAIS is currently considering a MAV approach for the*

<sup>20</sup> Two building blocks under two different capital frameworks cannot typically be added together if, as is frequently the case, each framework has a different scale for its ratios and thresholds. As discussed further below in section V, the BBA proposes to scale and equate capital positions in different frameworks through analyzing historical defaults under those frameworks.

*ICS; in contrast, the BBA aggregates existing company-level capital requirements throughout an organization to assess capital adequacy at various levels of the organization, including at the enterprise level. What are the comparative strengths and weaknesses of the proposed approaches? How might an aggregation-based approach better reflect the risks and economics of the insurance business in the U.S.?*

*Question 2: In what ways would an aggregation-based approach be a viable alternative to the ICS? What criteria should be used to assess comparability to determine whether an aggregation-based approach is outcome-equivalent to the ICS?*

The Board believes that the capital requirements proposed in this NPR advance the regulatory objectives of the Board as consolidated supervisor of insurance depository institution holding companies, including ensuring enterprise-wide safety and soundness, and protecting the subsidiary IDIs. Based on the Board's preliminary review, the Board does not anticipate that any currently supervised insurance depository institution holding company will initially need to raise capital to meet the requirements of the BBA. Moreover, the BBA is consistent with the Board's continuing emphasis on adopting a tailored approach to supervision and regulation in a manner that streamlines implementation burden.

#### *B. Dodd-Frank Act Capital Calculation*

In light of the requirements of the Dodd-Frank Act, in addition to the BBA, the Board is proposing to apply a separate minimum risk-based capital requirement calculation (the Section 171 calculation) to insurance depository institution holding companies that uses the flexibility afforded under the 2014 amendments to section 171 of the Dodd-Frank Act to exclude certain state and foreign regulated insurance operations and to exempt top-tier insurance underwriting companies.

As previously discussed, section 171 of the Dodd-Frank Act requires the Board to establish minimum risk-based and leverage capital requirements for depository institution holding companies. These requirements may not be less than the "generally applicable" capital requirements for IDIs, nor quantitatively lower than the capital requirements that applied to IDIs on July 21, 2010.<sup>24</sup> Section 171 of the

Dodd-Frank Act generally requires that the minimum risk-based capital requirements established by the Board for depository institution holding companies apply on a consolidated basis.

Notwithstanding the general requirement of section 171 of the Dodd-Frank Act that the minimum risk-based capital requirements established by the Board for depository institution holding companies apply on a consolidated basis, section 171(c) provides that the Board is not required to include for any purpose of section 171 (including in any determination of consolidation) any entity regulated by a state insurance regulator or a regulated foreign subsidiary or certain regulated foreign affiliates of such entity engaged in the business of insurance.

Currently, only a depository institution holding company that is a bank holding company or a "covered savings and loan holding company"<sup>25</sup> is subject to the Board's banking capital rule, which serves as the generally applicable capital requirement for IDIs and sets a floor for any capital requirements established by the Board for depository institution holding companies. Insurance depository institution holding companies are excluded from the definition of covered savings and loan holding company and from the application of the Board's banking capital rule on a consolidated basis. As a result, a top-tier SLHC that is significantly engaged in insurance activities and its subsidiary SLHCs currently are not subject to a consolidated minimum risk-based

appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act ("FDI Act") and "includes the regulatory capital components in the numerator of those capital requirements, the risk-weighted assets in the denominator of those capital requirements, and the required ratio of the numerator to the denominator."

<sup>25</sup> 12 CFR 217.1(c) and 217.2. Covered savings and loan holding company means a top-tier savings and loan holding company other than: (1) A top-tier savings and loan holding company that is:

(i) An institution that meets the requirements of section 10(c)(9)(C) of HOLA (12 U.S.C. 1467a(c)(9)(C)); and

(ii) As of June 30 of the previous calendar year, derived 50 percent or more of its total consolidated assets or 50 percent of its total revenues on an enterprise-wide basis (as calculated under GAAP) from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k));

(2) A top-tier savings and loan holding company that is an insurance underwriting company; or

(3) A top-tier savings and loan holding company that, as of June 30 of the previous calendar year, held 25 percent or more of its total consolidated assets in subsidiaries that are insurance underwriting companies (other than assets associated with insurance for credit risk).

capital requirement that complies with section 171 of the Dodd-Frank Act.

Under the proposed Section 171 calculation the Board's existing minimum risk-based capital requirements would generally apply to a top-tier insurance SLHC on a consolidated basis when this company is not an insurance underwriting company. In the case of an insurance SLHC that is an insurance underwriting company, the requirements would instead apply to any insurance SLHC's subsidiary SLHC that is not itself an insurance underwriting company and is not a subsidiary of any SLHC other than the insurance SLHC, provided that the subsidiary SLHC is the farthest upstream non-insurer SLHC (*i.e.*, the subsidiary SLHC's assets and liabilities are not consolidated with those of a holding company that controls the subsidiary for purposes of determining the parent holding company's capital requirements and capital ratios under the Board's banking capital rule) (an insurance SLHC mid-tier holding company). Except for the option to exclude insurance operations, which is described in further detail below, the minimum risk-based capital requirements that would apply for purposes of the Section 171 calculation are the same requirements that are applied under the generally applicable capital rules, and therefore ensure compliance with Section 171 of the Dodd-Frank Act.<sup>26</sup>

The proposed Section 171 calculation would be implemented by amending the definition of "covered savings and loan holding company" for the purposes of the Board's banking capital rule.<sup>27</sup> Under the proposal, an insurance SLHC would become a covered savings and loan holding company subject to the requirements of the Board's banking capital rule unless it is a grandfathered unitary savings and loan holding company that derives 50 percent or more of its total consolidated assets or 50 percent of its total revenues on an enterprise-wide basis (as calculated under GAAP) from activities that are not financial in nature.

<sup>26</sup> In its most basic form, for the Board's generally applicable minimum risk-based capital requirement, qualifying capital is the numerator of the ratio and risk-weighted assets (RWA) determine the denominator of the ratio. As used in this Supplementary Information, the terms "qualifying capital," "risk weight," and "risk-weighted assets" are used consistently with their uses under Federal banking capital rules. Under the Board's banking regulatory capital framework, the resulting ratio must be, at a minimum, 4.5 percent when considering common equity tier 1 (CET1) capital, 6 percent when considering total tier 1 capital, and 8 percent when considering total capital.

<sup>27</sup> 12 CFR 217.2.

<sup>24</sup> Section 171 of the Dodd-Frank Act defines the "generally applicable" risk-based capital requirements as those established by the



As a result of this amendment to the definition of “covered savings and loan holding company,” insurance SLHCs generally would become subject to the minimum risk-based capital requirements in the Board’s banking capital rule. However, under the proposed rule, top-tier holding companies that are engaged in insurance underwriting and regulated by a state insurance regulator, or certain foreign insurance regulators, would not be required to comply with the generally applicable risk-based capital requirements.<sup>28</sup> Instead, those requirements would apply to any insurance SLHC mid-tier holding companies, as defined in the proposed rule.

As noted, under the proposed Section 171 calculation, an insurance SLHC subject to the generally applicable risk-based capital requirements (*i.e.*, that is not a top-tier insurance underwriting company) could elect not to consolidate the assets and liabilities of all of its subsidiary state-regulated insurers and certain foreign-regulated insurers. By making this election, an insurance SLHC could determine that assets and liabilities that support its insurance operations should not contribute to the calculation of risk-weighted assets or average total assets under the generally applicable capital requirements.

With regard to the regulatory capital treatment of an insurance SLHC’s (or insurance mid-tier holding company’s) equity investment in subsidiary insurers that do not consolidate assets and liabilities with the holding company pursuant to the election, the proposal presents two alternative approaches for comment.<sup>29</sup> Under the first alternative, the holding company could elect to deduct the aggregate amount of its outstanding equity investment in its subsidiary state- and certain foreign-regulated insurers, including retained earnings, from its common equity tier 1 capital elements. Under the second alternative, the holding company could include the amount of its investment in its risk-weighted assets and assign to the investment a 400 percent risk weight,

consistent with the risk weight applicable under the simple risk-weight approach in section 217.52 of the Board’s banking capital rule to an equity exposure that is not publicly traded.<sup>30</sup> The Board recognizes that fully deducting from common equity tier 1 capital an insurance SLHC’s equity investment in insurance subsidiaries in some cases could yield inaccurate or overly conservative results for the section 171 calculation, for example, where the holding company has issued debt to fund equity contributions to the insurance subsidiaries. Conversely, any risk weight approach for equity investments in insurance subsidiaries must be calibrated to reflect risk, facilitate comparability of capital requirements for insurance and non-insurance depository institution holding companies, and avoid creating incentives for regulatory arbitrage. The Board continues to consider these issues, and invites comment on optional approaches to exclude insurance operations from the calculation of consolidated regulatory capital requirements.

As previously noted, in addition to risk-based capital requirements, section 171 requires the Board to establish minimum leverage capital requirements for depository institution holding companies. The Board’s banking capital rule includes a minimum leverage ratio of 4 percent tier 1 capital to average total assets.<sup>31</sup> The Board is not currently proposing a leverage capital requirement for insurance SLHCs under the BBA framework or as part of the section 171 compliance calculation, and continues to evaluate methodologies to apply leverage capital requirements to these institutions.

*Question 3: As an alternative to consolidation, what are the advantages or disadvantages of permitting a holding company to deconsolidate the assets and liabilities of its subsidiary state- and certain foreign-regulated insurers, and deduct from equity its investment in these subsidiary insurers?*

*Question 4: As an alternative to consolidation, what are the advantages or disadvantages of permitting a holding company to deconsolidate the assets and liabilities of its subsidiary state- and certain foreign-regulated insurers,*

*and risk weight the holding company’s equity investment in these subsidiary insurers?*

*Question 5: What is the appropriate risk weighting for a holding company’s equity investment in its subsidiary state- and certain foreign-regulated insurers?*

*Question 6: What other calculations, if any, should the Board consider to ensure that the minimum risk-based capital requirement for insurance depository institution holding companies complies with section 171 of the Dodd-Frank Act?*

*Question 7: Should the generally applicable minimum leverage ratio be excluded from the section 171 calculation?*

*Question 8: What are the advantages or disadvantages of applying the generally applicable minimum leverage capital requirement to an insurance SLHC or insurance SLHC mid-tier holding company, as defined in this proposal, with the same exclusion of insurance subsidiaries as set out in this proposal for the generally applicable minimum risk-based capital requirement?*

*Question 9: What are the advantages or disadvantages of applying a supplementary leverage ratio requirement to an insurance SLHC or insurance SLHC mid-tier holding company, as defined in this proposal, with the same exclusion of insurance subsidiaries as set out in this proposal for the generally applicable minimum risk-based capital requirement?*

A holding company electing to deconsolidate the assets and liabilities of all of its subsidiary state- and certain foreign regulated insurers would make this election, and indicate the manner in which it will account for its equity investment in such subsidiaries, on the applicable regulatory report filed by the holding company for the first reporting period in which it is subject to the Section 171 calculation. A holding company seeking to make such an election at a later time, or to change its election due to a change in control, business combination, or other legitimate business purpose, would be required to receive the prior approval of the Board.

*Question 10: What would the benefits and costs be of allowing a holding company to elect not to consolidate some, but not all, of its subsidiary state- and certain foreign-regulated insurers?*

*Question 11: When should the Board permit a holding company to request to change a prior election regarding the capital treatment of its insurance subsidiaries?*

<sup>28</sup> In accordance with section 171 of the Dodd-Frank Act, a foreign insurance regulator that fall under this provision is one that “is a member of the [IAIS] or other comparable foreign insurance regulatory authority as determined by the Board of Governors following consultation with the State insurance regulators, including the lead State insurance commissioner (or similar State official) of the insurance holding company system as determined by the procedures within the Financial Analysis Handbook adopted by the [NAIC].”

<sup>29</sup> The amount of the holding company’s outstanding equity investment, including retained earnings, in a subsidiary insurer can be best determined as the equity of the subsidiary under U.S. GAAP.

<sup>30</sup> 12 CFR 217.52(b)(6).

<sup>31</sup> Under the Board’s banking capital rule, the leverage ratio is the ratio of tier 1 capital to average total consolidated assets as reported on the Call Report, for a state member bank, or the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), for a bank holding company or savings and loan holding company, as applicable minus amounts deducted from tier 1 capital under 12 CFR 217.22(a), (c) and (d). See 12 CFR 217.10(b)(4).



## IV. The Building Block Approach

### A. Structure of the BBA

The proposed BBA is an approach to a consolidated capital requirement that aggregates the capital positions of companies under an insurance depository institution holding company, adjusted as prescribed in the proposed rule, and scaled to a common capital framework. The proposed BBA would group companies into subsets of the full enterprise, called building blocks, where the company that owns or controls each building block is termed a “building block parent.” The purpose of a building block is to group together companies generally falling under the same capital framework (namely, the framework of the building block parent). Each building block parent’s applicable capital framework would be used to determine that parent’s capital position.<sup>32</sup> The proposed BBA would scale or convert the capital positions of non-insurance building block parents to their insurance building block parent equivalents and then aggregate the capital positions to reach an enterprise-wide capital position. In this manner, the BBA reflects the risks and resources of the subsidiaries within each building block and, thus, a consolidation of all material risks in the insurance depository institution holding company’s enterprise.

An important part of applying the BBA is identifying the building block parents in an insurance depository institution holding company’s enterprise. Section IV.C below discusses the steps to determine the building block parents, including identifying an inventory of companies from which building block parents are identified based on the applicable capital framework assigned to the companies for use in the BBA. Ultimately, all of the building blocks are aggregated into the top-tier depository institution holding company’s building block, thereby resulting in an amount of available capital and capital requirement for the top-tier depository institution holding company used to calculate its BBA ratio.

<sup>32</sup> For instance, if a particular building block parent is a U.S. operating insurer, the applicable capital framework would be NAIC RBC as adopted by the insurer’s domiciliary state. In the BBA, all of the parent’s subsidiaries would be reflected in the manner that they are treated under NAIC RBC. If a building block parent is an insured depository institution, the applicable capital framework would be Federal bank capital rules. In the BBA, the IDI’s subsidiaries would be consolidated and reflected through the IDI’s capital position in accordance with the Federal banking capital rules.

### B. Covered Institutions and Scope of the BBA

The proposed BBA would apply to depository institution holding companies significantly engaged in insurance activities. The Board proposed in the ANPR that a firm would be subject to the BBA if the top-tier parent were an insurance underwriting company or 25 percent of its total assets were in insurance underwriting subsidiaries. In this NPR, the Board proposes to leave this threshold unchanged. A firm would be subject to the BBA if: (1) The top-tier DI holding company is an insurance underwriting company; (2) the top-tier DI holding company, together with its subsidiaries, holds 25 percent or more of its total consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit risk related to bank lending);<sup>33</sup> or (3) the firm has otherwise been made subject to the BBA by the Board.

As consolidated supervisor of the top-tier DI holding company of an insurance depository institution holding company, the Board proposes to include, within the scope of the BBA calculation, all owned or controlled subsidiaries of this top-tier parent.<sup>34</sup> While the Board could have opted to exclude certain subsidiaries (e.g., those that are immaterial), the Board considers that a capital requirement including all owned or controlled companies within the scope of the BBA better reflects a consolidated, enterprise-wide perspective of the risks faced by the insurance depository institution holding company. Companies that are not owned or controlled by a top-tier DI holding company and that do not own or control an IDI would fall outside of the BBA’s scope. For instance, a top-tier DI holding company may have a sister company that does not control an IDI.

<sup>33</sup> For purposes of this threshold, a supervised firm would calculate its total consolidated assets in accordance with U.S. GAAP, or, if the firm does not calculate its total consolidated assets under U.S. GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board.

<sup>34</sup> The Board recognizes that, where a firm’s structure includes a number of companies that control an IDI, it may be more practical and efficient, particularly in terms of reducing implementation burden, to treat, for purposes of the BBA, a mid-tier entity as the top-tier SLHC with the upstream controlling entity(ies) left outside of the BBA’s scope. For instance, if an insurance institution is controlled by a company significantly engaged in non-insurance, commercial activities, it may be practical, and without compromising the quality of the Board’s consolidated supervision, to focus the BBA’s application on the insurance institution rather than the broader commercial enterprise.

The sister company would fall outside of the scope of the BBA’s application because it lacks the requisite connection to the IDI. Under a different structure, an insurance depository institution holding company may control an IDI that is also controlled by another insurance depository institution holding company, where both insurance depository institution holding companies are part of the same organization generally regarded as a single group. Both of these top-tier DI holding companies would be within the BBA’s scope.

Currently, the insurance depository institution holding companies are all SLHCs and the current proposed definition of top-tier depository institution holding company in the BBA only encompasses SLHCs. However, it is possible for a bank holding company (which is also a depository institution holding company under the FDI Act) to be significantly engaged in insurance activities as determined by applying the threshold described earlier in this section. In particular, under the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA),<sup>35</sup> Federal savings associations with total consolidated assets of up to \$20 billion, as reported to the Office of the Comptroller of the Currency (OCC) as of year-end 2017, may elect to operate as a covered savings association.<sup>36</sup> The Board is still considering these recent legislative changes. However, the Board presently does not see reason to apply different capital requirements to an insurance depository institution holding company that controls a covered savings association and an insurance depository institution holding company that controls any other IDI. Preliminarily, the Board anticipates harmonizing the regulation of BHCs and SLHCs significantly engaged in insurance activities, in each case determined by applying the threshold described earlier in this section. This could result in BHCs significantly engaged in insurance activities falling within the scope of the final rule implementing the BBA.

*Question 12: What are the advantages and disadvantages of including all insurance depository institution holding companies (including bank holding companies significantly engaged in insurance activities and insurance depository institution holding companies that control covered savings associations) within the scope of the final BBA rule, as planned?*

<sup>35</sup> Public Law 115–174, 132 Stat. 1296 (2018).

<sup>36</sup> EGRRCPA Section 206.

### *C. Identification of Building Blocks and Building Block Parents*

#### 1. Inventory

In order to identify the set of companies that would be grouped into building blocks and aggregated, an insurance depository institution holding company would first identify an inventory of all companies in its enterprise. Some of the companies in the inventory would be building block parents. The remaining companies would be assigned to building block parents.

To construct the inventory, the Board prefers including a broad set of companies that reflects the firm's full enterprise under the BBA's scope and provides an appropriately wide range of candidates for building block parents. A framework for constructing the inventory that relied on, for instance, the definitions of "control" under U.S. GAAP may be burdensome to apply and set a relatively higher bar for inclusion of affiliates, resulting in too few companies appearing on the inventory. The Board notes that the NAIC's Schedule Y, filed annually as part of the SAP financial statements, is advantageous in utilizing a standard for "control" that enables more subsidiaries and affiliates to be included.

Because it is possible that certain banking, SLHC, or nonbanking companies may not appear on the supervised firm's Schedule Y (but would appear on the firm's regulatory filings with the Board), the Board sought to augment the inventory by adding to the set of companies obtained from Schedule Y the companies appearing on the Board's Forms FR Y-6 and FR Y-10. These forms use a definition of control setting out scenarios where one company has control over another through a variety of ways, including ownership, control of voting securities, and management agreements. The Board considers that through the combination of companies appearing on Forms FR Y-6 and FR Y-10, and the NAIC's Schedule Y,<sup>37</sup> the BBA would reflect a sufficiently wide set of companies as potential building block parents as well as capturing all material risks. Moreover, by utilizing reports already prepared by insurance depository institution holding companies, including those reported to state insurance regulators, the BBA proposal

aims to minimize burden in the process of inventorying companies.

While the inventory in the BBA will generally comprise the companies shown on the forms discussed above, the Board also seeks to ensure that the supervised firm's organizational and control structure does not materially alter the scope of risks that the BBA considers. Firms may engage in transactions with counterparties not shown on these forms, where these transactions have the effect of transferring risk or evading application of the BBA. For such circumstances, the BBA includes a mechanism to include these counterparties in the inventory.

As discussed below, applying the BBA and performing its calculations rests on identifying the building block parents among the companies in the inventory. Once these building block parents are identified, all of their subsidiaries, whether or not listed on the inventory, would fall within the scope of the BBA.

An illustration of this step in applying the BBA is presented in Section IX.A.

#### 2. Applicable Capital Framework

In the BBA, the term "applicable capital framework" refers to a regulatory capital framework that is used to determine whether a company should be a building block parent, and, once a company is assigned to a building block, to measure the capital resources of that company and the amount of risk the company contributes to the overall enterprise. Once a company is identified as a building block parent, its applicable capital framework would be used to reflect the capital position across all of the subsidiaries in the building block, including subsidiaries that are not directly subject to any regulatory capital framework.

For the insurance operations, insurance capital requirements are likely to best reflect the underlying risks.<sup>38</sup> For instance, the applicable capital framework for U.S. insurance operating companies may be life or property and casualty (P&C) risk-based

capital (RBC). The Board's proposal to use the regulatory capital framework promulgated by the NAIC for an insurance company or operation as the applicable capital framework (*e.g.*, the P&C RBC for a P&C insurer) takes into consideration the NAIC capital framework's reflection of the potential impact of various risk exposures, including liabilities, on the solvency of that type of insurer. For material insurance companies that lack a regulatory capital framework for which scaling can be performed under the BBA, such as some captive insurance companies, the Board proposes to apply the NAIC's RBC, after restating such companies' financial information according to SAP.<sup>39</sup>

For banking companies, the Board was mindful of the reflection of risks in the banking capital requirements. The Board proposes to incorporate the regulatory capital framework established for a depository institution by its primary Federal banking regulator as the depository institution's applicable capital framework, because the capital framework has been calibrated to reflect the potential impact of various risk exposures common to banking organizations (primarily in the form of assets) on the risk profile of a depository institution. In particular, an IDI's applicable capital framework is determined as follows:<sup>40</sup> For nationally-chartered IDIs, the applicable capital framework is the capital rule as set forth by the OCC.<sup>41</sup> For state-chartered IDIs that are members of the Federal Reserve System, the applicable capital framework is the Board's banking capital rule, and for those that are not members, the capital rule as set forth by the FDIC.<sup>42</sup> In addition, applying bank capital requirements to certain other non-insurance subsidiaries, referred to in the BBA as "material financial entities" (MFEs), can mitigate the risk of regulatory arbitrage by disincentivizing the reallocation of assets between banking, insurance, and other companies in the institution. Where the rule proposes to apply Federal bank capital rules, insurance depository institution holding companies would apply them using the same elections (*e.g.*, treatment of accumulated other

<sup>38</sup> As discussed further below, the insurance operations in an insurance building block can encompass operating insurers and subsidiaries that are not subject to a regulatory capital framework. Unless those subsidiaries are later assigned to a bank building block, through the operations discussed below, the treatment of these companies under insurance capital rules would be used in the BBA. To best reflect the risks in the enterprise while streamlining implementation burden, the Board proposes to apply this treatment rather than applying the Board's banking capital rule universally to noninsurance companies. As discussed below, those that are material may meet the definition of a material financial entity and, where applicable, be treated under the Board's banking capital rule.

<sup>39</sup> A discussion of the proposed BBA's definition of "material" appears in Section IV.C.3.

<sup>40</sup> Note that a foreign bank would typically not meet the definition of an IDI, which includes entities whose deposits are insured by the FDIC without regard to whether the entity's deposits are insured by any other program. In the BBA, any foreign bank would be subject to the Board's banking capital rule.

<sup>41</sup> 12 CFR part 3, 12 CFR part 167.

<sup>42</sup> 12 CFR part 324; 12 part CFR 217.

<sup>37</sup> The Schedule Y used for this purpose is the one included in the most recent statutory annual statement for an operating insurer in the insurance depository institution holding company's enterprise.

comprehensive income) as they would when applying bank capital rules to a subsidiary IDI.<sup>43</sup>

The Board proposes to include, within the scope of the BBA, the insurance depository institution holding company predominantly engaged in title insurance through a tailored application of the Board's banking capital rule.<sup>44</sup> The NAIC has not promulgated a risk-based capital standard for title insurance companies. In the absence of an insurance capital framework for title insurance, and in light of the different nature of title insurance compared with life and P&C insurance, the Board has determined to apply the Board's banking capital rule to an insurance depository institution holding company predominantly engaged in title insurance. Currently, there is one insurance depository institution holding company that is predominantly engaged in title insurance. The Board's proposed application of the BBA to this firm is facilitated by the fact that the title insurance depository institution holding company, like other large title insurers, prepares consolidated financial

statements in accordance with U.S. GAAP.

As a simplified example of the determination of companies' applicable capital frameworks, consider an insurance depository institution holding company consisting of a life insurance top-tier parent with two subsidiaries, a P&C insurer and the IDI. Each of these companies would fall under a different applicable capital framework, namely, for the top-tier parent, NAIC RBC for life insurance; for the P&C subsidiary, NAIC RBC for P&C insurance; and for the IDI, the appropriate Federal banking capital rule. A further illustration of this step in applying the BBA is presented in Section IX.B.

*Question 13: The Board invites comment on the proposed approach to determine applicable capital frameworks. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?*

### 3. Building Block Parents

Under the proposed BBA, a building block parent can be one of several different types of companies. The first is the top-tier depository institution holding company. In the absence of any other identified building block parents, the top-tier depository institution holding company's building block would contain all of the top-tier depository institution holding company's subsidiaries. A second type of building block parent is a mid-tier holding company that is a "depository

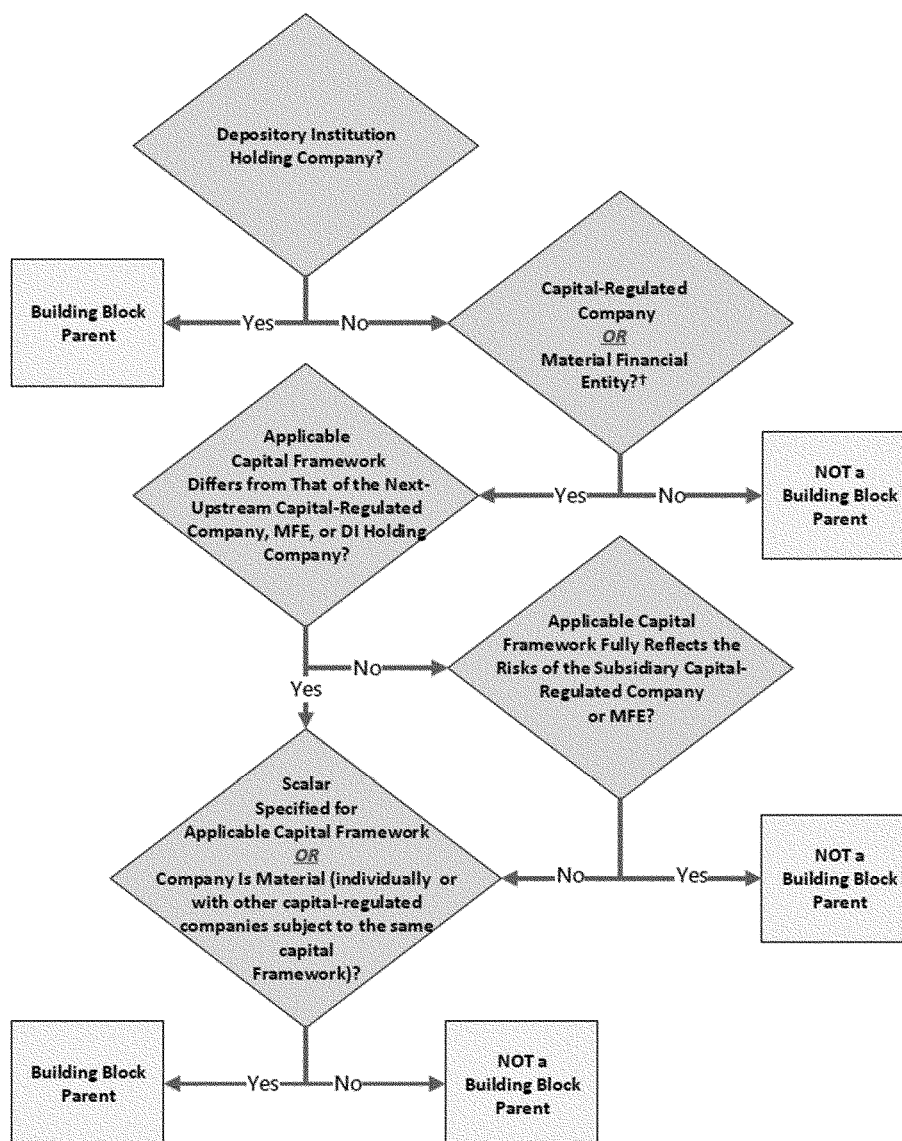
institution holding company" under U.S. law. Treating these companies as building block parents will allow for the calculation of a separate BBA ratio at the level of these companies in the enterprise and help to ensure that these companies remain appropriately capitalized. The balance of this subsection discusses the remaining types of building block parents.

#### (a) Capital-Regulated Companies and Material Financial Entities as Building Block Parents

For two categories of companies that could be identified as building block parents, companies that are subject to company-level capital requirements (capital-regulated companies) and MFEs, the analysis is conducted in the same manner. For each of these companies in the inventory, the supervised firm analyzes whether that company's applicable capital framework differs from that of the next capital-regulated company, MFE, or DI holding company encountered when proceeding upstream in the supervised firm's inventory. If so, that company is identified as a building block parent. The identification of building block parents, particularly capital-regulated companies and material financial entities, can be illustrated through the following decision tree, which would be applicable for each company in the insurance depository institution holding company's enterprise.

<sup>43</sup> This accords with the rule set out in 12 CFR 217.22(b)(2)(iii), which specifies that "Each depository institution subsidiary of a Board-regulated institution that is not an advanced approaches Board-regulated institution must elect the same option as the Board-regulated institution pursuant to [12 CFR 217.22(b)(2)]."

<sup>44</sup> Later sections in this Supplementary Information discuss aspects of applying the Board's banking capital rule to the insurance depository institution holding company predominantly engaged in title insurance.

*Decision Tree Depicting Identification of Building Block Parents\**

\* In addition to the identifications noted in the decision tree:

- Inventory companies identified pursuant to the proposed provisions concerning the Board's reservation of authority, structures intended to evade application of the rule, or certain inventory companies owned by members of more than one building block, are building block parents;
- A company that otherwise would be a building block parent, but, pursuant to the proposed provision concerning the Board's reservation of authority, is deemed to not be a building block parent.

† Certain companies (investment advisers under the Investment Advisers Act of 1940, financial subsidiaries as defined in Section 121 of the Gramm-Leach-Bliley Act (GLBA), Pub. L. 106-102, 113 Stat. 1338, 1471, 12 U.S.C. 4809, and companies whose risks are allocated to intra-group transaction counterparties as discussed below) are ineligible to be MFEs.

For example, if a firm's top-tier depository institution holding company is a life insurer that has two direct subsidiaries—a P&C insurer and the IDI—the firm would analyze whether the P&C company's applicable capital framework (NAIC RBC for P&C insurers) differs from that of the top-tier DI holding company (NAIC RBC for life insurers). Upon finding that the applicable capital frameworks are different, the P&C insurer would be a building block parent. The same would be the case for the IDI, whose applicable capital framework (a Federal banking capital rule) differs from the capital framework of its life insurance parent. However, if the P&C subsidiary has a further downstream P&C subsidiary, the firm would compare the latter P&C company's applicable capital framework only against that the P&C subsidiary immediately below the life insurer.<sup>45</sup> Thus, the downstream P&C subsidiary would not be identified as a building block parent.

If the capital framework of a capital-regulated company or MFE is the same as that of the next-upstream capital-regulated company, MFE, or DI holding company, generally the companies will remain in the same building block except for one case. This exceptional case is where a company's applicable capital framework treats the company's subsidiaries in a way that does not substantially reflect the subsidiary's risk. For instance, there are situations in which NAIC RBC may not fully reflect the risks in certain subsidiaries (typically, certain foreign subsidiaries) that assume risk from affiliates.<sup>46</sup> In such cases, the subsidiary (which could be a capital-regulated company or MFE) would be identified as a building block parent so that its risks can more appropriately be reflected in the BBA.

While the current population of insurance depository institution holding companies does not include material non-U.S. operations, additional considerations in identifying capital-regulated companies as building block parents may arise in cases of an insurance depository institution holding company's insurance subsidiaries subject to non-U.S. capital frameworks.

<sup>45</sup> Although the downstream P&C subsidiary has two companies upstream of it—the life parent and its direct subsidiary P&C insurer—the downstream P&C subsidiary's applicable capital framework would only be compared against the framework of the next-upstream capital regulated company.

<sup>46</sup> The BBA proposes to apply NAIC RBC to such subsidiaries. However, under state laws, the application of NAIC RBC on the parent would not normally operate to include the available and required capital from applying NAIC RBC to the subsidiary. However, when the is identified as a building block parent in the BBA, the subsidiary's available and required capital under NAIC RBC would be reflected by the parent after aggregation.

Whether such companies can be identified as building block parents depends on whether the companies' applicable capital frameworks can be scaled to NAIC RBC, the common capital framework used in the BBA. If a scalar has been developed for the applicable capital framework, the capital-regulated non-U.S. insurance subsidiary would be identified as a building block parent. Where a scalar has not been developed for the applicable capital framework, but the aggregate of the enterprise's companies falling under the non-U.S. insurance capital framework is material,<sup>47</sup> the BBA proposes a provisional scaling approach so that these companies could be identified as building block parents. In all other cases, capital-regulated non-U.S. insurance subsidiaries would not be identified as building block parents.

As discussed above, an MFE is a financial entity that is material, subject to certain exclusions. The proposed definition of "financial entity" in the BBA enumerates several types of companies engaged in financial activity consistent with similar enumerations in other rules applied by the Board. To develop the proposed definition of "financial entity," the Board began with the definition of the same term under the Board's existing rules,<sup>48</sup> and made modifications to tailor to insurance enterprises and the BBA (principally, the removal of the prong for employee benefit plans, since these are unlikely to exist under insurance depository institution holding companies).

The proposed definition of materiality consists of two parts. In the first part, a company is presumed to be material if the top-tier depository institution holding company has exposure to the company exceeding 1 percent of the top-tier's total assets.<sup>49</sup> In this context, "exposure" includes:

- The absolute value of the top-tier depository institution holding company's direct or indirect interest in the company's capital;
- the top-tier depository institution holding company or any of its subsidiaries providing an explicit or implicit guarantee for the benefit of the company; and
- potential counterparty credit risk to the top-tier depository institution holding company or any subsidiary

<sup>47</sup> The proposed BBA's application of the term "material" is discussed below.

<sup>48</sup> See 12 CFR 252.71(r).

<sup>49</sup> The supervised firm must calculate its total consolidated assets in accordance with U.S. GAAP, or if the firm does not calculate its total consolidated assets under U.S. GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board.

arising from any derivatives or similar instrument, reinsurance or similar arrangement, or other contractual agreement.

There may be cases in which these enumerated presumptions may not fully capture subsidiaries that are otherwise material. To accommodate these cases, the second part of the proposed definition of "material" would consider a subsidiary to be material when it is significant in assessing the insurance depository institution holding company's available capital or capital requirements. Factors that indicate such significance include risk exposure, activities, organizational structure, complexity, affiliate guarantees or recourse rights, and size.<sup>50</sup> This definition, tailored to insurance and the BBA, accords with the Board's prior rulemakings and actions utilizing considerations of materiality.<sup>51</sup>

*Question 14: What other definitions of materiality, if any, should the Board consider for use in the BBA? Examples may include a threshold based on size, off-balance sheet exposure, or activities including derivatives or securitizations.*

*Question 15: What thresholds, other than the proposed threshold for exposure as a percentage of total assets, should the Board consider for use in the BBA's definition of materiality? What are advantages and disadvantages of using a threshold based on the top-tier depository institution holding company's building block capital requirement?*<sup>52</sup>

The notion of a material financial entity is proposed to address a variety of companies not subject to a capital requirement and that could pose risk to the safety and soundness of the insurance depository institution holding company or its subsidiary IDI. For instance, an insurance depository institution holding company may have a material derivatives trading subsidiary not presently subject to any capital framework. Additionally, a company under an insurance depository institution holding company may serve as a funding vehicle for other companies in the institution, borrowing and downstream funds to affiliates.

<sup>50</sup> Here, the consideration of significance reflects the potential to influence the Board's supervisory judgments and assessments of the insurance depository institution holding company.

<sup>51</sup> See 12 CFR part 243 (Regulation QQ) and Reporting Form FR 2052b.

<sup>52</sup> To reconcile a potential circularity of having a definition of materiality that relies on the current year's building block capital requirement, the threshold could be based on the company capital requirement of the capital-regulated company in the supervised insurance organization with the greatest assets, for the first year, and the prior year's building block capital requirement for the top-tier depository institution holding company for subsequent years.

Among other companies that could be MFEs are certain insurance companies that exist to reinsure risk from affiliates. The Board proposes that when such companies, and the insurance depository institution holding company's use of and transactions with such companies, could pose material financial risk to the insurance depository institution holding company, such companies' financial information should be restated in accordance with SAP.<sup>53</sup> Such companies as restated should be subjected to capital treatment under RBC and included in the BBA as MFEs.

The BBA includes certain exceptions whereby companies that are financial entities and material would nonetheless not be treated as MFEs. Where a company primarily functions as an intermediary through which other companies within the insurance depository institution holding company's enterprise conduct activities (e.g., manage or hedge risk through the use of reinsurance or derivatives or investment partnerships), the proposed BBA allows the insurance depository institution holding company to elect to not treat such a company as an MFE. In such a case, the firm would be required to allocate the company's risks to other companies within the insurance depository institution holding company's enterprise.

In addition, the Board proposes that certain types of companies would be ineligible to be MFEs: A financial subsidiary as defined in GLBA Section 121 and a subsidiary primarily engaged in asset management. In the case of a financial subsidiary, the equity of these subsidiaries is deducted, and the assets and liabilities not consolidated, under the Board's banking capital rules. Treating such a subsidiary as an MFE, and calculating qualifying capital and RWA for such a subsidiary, may not fully accord with the Board's current banking capital rules.

In the case of a subsidiary primarily engaged in asset management, the Board considers that a registered investment adviser under the Investment Advisers Act of 1940 would not be an MFE. As a non-insurance company, the applicable capital regime under the BBA for an investment adviser would be the Federal banking capital rules. These rules are built on the calculation of RWA and presently do not have dedicated, robust, and risk-sensitive

treatment of operational risk. Moreover, investment advisers do not typically report all assets under management on their balance sheets and can face substantial operational risk. As such, measuring these subsidiaries' capital positions using the Board's banking capital rules may not provide a complete depiction of the subsidiaries' risks. Furthermore, in insurers' organizational structures, asset manager subsidiaries can exist under non-operating or shell holding companies. To the extent that such holding companies under insurance depository institution holding companies are not engaged in financial activities, they would not constitute financial entities under the BBA.

*Question 16: The Board invites comment on the use of the material financial entity concept. What are the advantages and disadvantages to the approach? What burden, if any, is associated with the proposed approach?*

*Question 17: The Board invites comment on the proposed treatment of intermediaries. What are the advantages and disadvantages of the approach? What burden, if any, is associated with the proposed treatment?*

*Question 18: What risk-sensitive approaches could be used to address the risks presented by asset managers in an insurance depository institution holding company's enterprise?*

*Question 19: What forms or structures, if any, do asset managers or their holding companies take in insurance enterprises, such that they may fall within the proposed definition of an MFE?*

#### (b) Other Instances of Building Block Parents

The BBA allows for three additional cases in which a company is identified as a building block parent. First, a company is a building block parent when it is:

- Party to one or more reinsurance or derivative transactions with other inventory companies;
- Material; and
- Engaged in activities such that one or more inventory companies are expected to absorb more than 50 percent of its expected losses.

Second, the case could arise where a company under an insurance depository institution holding company is jointly owned by more than one building block parent, where the jointly owned company is not itself a building block parent. Furthermore, the company may be consolidated in the applicable capital framework of one or more of the building block parents. In such a case, the aggregation in the BBA could result

in double counting of the risks and resources of the jointly-owned company. To avoid this outcome, the proposed BBA would identify the jointly-owned company as a building block parent, whereupon the aggregation and consideration of allocation shares, discussed below, would avoid double-counting.

Finally, depending on an insurance depository institution holding company's organizational structure, it may be more convenient or less burdensome to treat, as a building block parent, a company that is not identified as such through the operations described above, or vice versa.

Each of these cases of identifying or declining to identify building block parents is achieved through the reservation of authority provision proposed in the BBA.<sup>54</sup> Factors that the Board may consider in determining to treat or not treat a company in an insurance depository institution holding company's enterprise as a building block parent in this manner include, but are not limited to, operational ease or convenience in applying the BBA, adequate risk sensitivity and reflection of risks posed to the safety and soundness of the supervised institution and/or its subsidiary IDI, and minimizing implementation burden in the insurance depository institution holding company's fulfillment of regulatory reporting and compliance requirements.<sup>55</sup> Moreover, certain transaction structures result in material risks being moved outside of regulatory capital frameworks, or moved to regulatory capital frameworks that do not fully reflect these risks.<sup>56</sup> The BBA accommodates such scenarios by reserving for the Board the authority to make adjustments to the set of inventory companies that are building block parents.

An illustration of this step in applying the BBA is presented in Section IX.C below.

*Question 20: Are the additional instances where the Board proposed to identify building block parents appropriate? For example, with regard to a company that would be a building*

<sup>54</sup> See proposed Section 601(d)(3).

<sup>55</sup> Likewise, this provision allows the Board to not treat a company as a building block parent where that company would be a building block parent by operation of the rule. The same considerations identified here could guide the Board in the exercise of this authority.

<sup>56</sup> Such transactions could include, among other things, certain reinsurance or derivative transactions involving a counterparty that was formed or acquired by or on behalf of the insurance depository institution holding company where no inventory company has more than a negligible ownership stake in the counterparty.

<sup>53</sup> This application of SAP would be consistent with the way SAP is applied in the BBA, reflecting the proposed adjustments. One such adjustment that is relevant is the use of Principle-Based Reserving (PBR) on business that is currently grandfathered. See section VI.B.3.

*block parent because it is a party to one or more reinsurance or derivative transactions with other inventory companies, is material, and is engaged in activities such that one or more inventory companies are expected to absorb more than 50 percent of its expected losses, would a different level of expected losses (i.e., a level other than 50 percent) be more appropriate?*

#### D. Aggregation in the BBA

After identifying all of the building block parents and their applicable capital frameworks, the BBA would determine available capital and capital requirements, make appropriate adjustments and translate as needed to the common capital framework used in the BBA, the NAIC's RBC. The BBA uses a bottom up approach to aggregation. This approach will generate a BBA ratio for each company in the organization that is a depository institution holding company under the FDI Act, i.e., the top tier depository institution holding company and any mid-tier depository institution holding company. The top tier parent and any subsidiary depository institution holding company may be subject to a capital framework other than the NAIC's RBC. In that instance, the building block available capital and building block capital requirement are scaled to NAIC RBC to compute the BBA ratio that those levels in the organizational structure.

The purpose of aggregating companies within the BBA is to reflect the ownership interests of building block parents in subsidiaries and affiliates in order to provide an accurate measure of available capital without double counting. In the BBA, this is achieved by determining a building block parent's "allocation share" of any downstream building block parent. The following three examples may further illustrate the determination of allocation shares in the proposed BBA:

- An upstream company that is a building block parent (upstream building block parent) owns 100 percent of a subsidiary that is also a building block parent (downstream building block parent). The downstream building block parent's available capital is comprised solely of the equity owned by the upstream building block parent.
- The upstream building block parent's allocation share in the downstream building block parent is 100 percent.

- An upstream building block parent (BBP A), and another building block parent (BBP B) at the same level in the corporate hierarchy as BBP A, together own a downstream building block

parent, where BBP A owns 30 percent and BBP B owns 70 percent.

- BBP A's allocation share in the downstream building block parent is 30 percent and BBP B's allocation share is 70 percent.

- Upstream building block parents BBP A and BBP B jointly own a downstream building block parent, where BBP A owns 30 percent and BBP B owns 70 percent. In addition, BBP A owns a surplus note issued by the downstream building block parent, which represents 20 percent of the downstream building block parent's available capital. Consider further that the carrying value of the downstream building block parent (and its capital excluding the surplus note) is \$100 million and the surplus note is for \$25 million.

- BBP A's allocation share is the surplus note (\$25 million) plus its prorated share of the downstream building block parent's equity (\$30 million), divided by the downstream building block parent's total available capital (\$125 million), or 44 percent. BBP B's allocation share is 56 percent.

As a simple example, consider the hypothetical insurance depository institution holding company presented in Section IV.C.2. Suppose the life parent's Total Adjusted Capital (TAC) is \$500 million and its Authorized Control Level (ACL) RBC is \$100 million. Suppose the P&C subsidiary's TAC and ACL are \$40 million and \$10 million, respectively. Aggregating the P&C subsidiary and life parent is seamless, since the life parent's RBC figures already include the P&C subsidiary, i.e. before and after aggregation of the P&C subsidiary under the BBA, the life parent's TAC and ACL are the same. For the life parent's subsidiary IDI, suppose the IDI's total capital is \$27 million and its RWA is \$150 million. After scaling (see the scaling parameters and explanation of this example in Section V below), its available capital is \$17.5 million and its capital requirement is \$1.6 million. Suppose the life parent's carrying value of the subsidiary IDI is \$30 million, and the IDI's contribution to the life parent's ACL is \$2 million. Aggregating the IDI into the life parent in accordance with the BBA results in available capital of \$487.5 million,<sup>57</sup> and capital requirement of \$99.6 million.<sup>58</sup>

<sup>57</sup> This is calculated as the life parent's TAC (\$500 million), minus its carrying value of the IDI (\$30 million), plus the IDI's scaled total capital (\$17.5 million).

<sup>58</sup> This is calculated as the life parent's ACL RBC (\$100 million), minus the contribution to ACL by the IDI (\$2 million), plus the IDI's scaled capital requirement (\$1.6 million).

A further illustration of this step in applying the BBA is presented in Section IX.G.

*Question 21: How can the Board improve the calculation of allocation share? Should the Board further clarify the data sources for the inputs to the allocation share calculation? Would it be better to use a simpler methodology, such as relying only on common equity ownership percentages?*

#### V. Scaling Under the BBA

##### A. Key Considerations in Evaluating Scaling Mechanisms

In the BBA, the calculation referred to as "scaling" translates a company's capital position under one capital framework to its equivalent capital position in another framework. This translation allows appropriate comparisons and aggregation of metrics. In evaluating different approaches to determining scalars, the Board was primarily informed by considerations including reasonableness of the approaches' assumptions, ease of implementation, and stability of the parametrization resulting from the approaches. Reasonable assumptions include those that are reflective of supervisory experience, as opposed to those that are crude and unlikely to produce accurate translations. Ease of implementation refers to the ease with which scaling parameters can be derived in an approach, which can vary based on availability of data on companies' experience under a framework. The stability of parametrization refers to the extent to which changes in assumptions or data affect the value of scaling parameters.

As an Appendix to this proposed rule, the Board is publishing a white paper that supplements the determination of the scaling parameters in this proposed rule.<sup>59</sup> The white paper identifies and assesses a number of approaches to developing scalars, and helps explain the underlying assumptions and analytical framework supporting the scaling approach and equations proposed in this rule. The Board has incorporated that analysis in its consideration and is publishing the white paper to make it more accessible to the public.

##### B. Identification of Jurisdictions and Frameworks Where Scalars Are Needed

Because all of the current insurance depository institution holding

<sup>59</sup> See *Comparing Capital Requirements in Different Regulatory Frameworks* (2019). The Board relied on the white paper, including the explanations and analysis contained therein, in this rulemaking and incorporates it by reference.



companies are U.S.-based insurers that own IDIs, which are subject to Federal bank capital rules, scaling from the Board's banking capital rule to the NAIC's RBC (and vice versa) will be needed in the BBA. The Board also performed an analysis to determine whether scaling between any other capital frameworks would currently be needed.

With regard to scaling between U.S. and non-U.S. jurisdictions (e.g., non-U.S. insurance to U.S. insurance), the Board reviewed the companies under each insurance depository institution holding company that would be subject to this proposal using the Board's existing supervisory data cross-referenced with data available from the NAIC. Because all foreign non-insurance operations would be analyzed using the Board's banking capital rule, the Board focused on non-U.S. insurance operations. None of the non-U.S. insurance subsidiaries of current insurance depository institution holding companies appeared to be material to their group. The Board therefore is not presently proposing scaling for non-U.S. insurance capital frameworks.<sup>60</sup>

### C. The BBA's Approach to Determining Scalars

After considering potential scaling methods and the analysis in the referenced white paper, the Board proposes to use an approach to scaling in the BBA based on historical bank and insurer default data (the probability of default approach). The proposal uses historical default rates to analyze the meaning of solvency ratios and preserves this in translating values between capital frameworks. While default definitions can be difficult to align across capital frameworks, an underlying purpose of many solvency ratios is to assess the probability of a firm defaulting and default data currently appears to be the best available economic benchmark for capitalization metrics.

Using the probability of default approach, the Board proposes to use the following scaling formulas, which are explained more fully in the referenced white paper. The first equation below calculates the equivalent ACL under NAIC RBC based on an amount of risk-weighted assets under Federal banking capital rules. The second equation below calculates TAC under NAIC RBC,

based on an amount of tier 1 plus tier 2 qualifying capital under Federal banking capital rules. The third and fourth equations cover scaling back from NAIC RBC to Federal banking capital rules.

1. NAIC ACL RBC =  $0.0106 * RWA$
2. NAIC TAC = (Banking Rule Total Capital) -  $0.063 * RWA$
3.  $RWA = 94.3 * NAIC\ ACL\ RBC$
4. Banking Rule Total Capital = NAIC TAC +  $5.9 * NAIC\ ACL\ RBC$

This scaling approach reflects a total balance sheet perspective.<sup>61</sup> Available capital under two different frameworks may have differences that distort the picture of a firm's capital position in one framework compared with the other. U.S. GAAP is based on a going-concern assumption. By contrast, U.S. SAP is generally more conservative, based on a liquidation (realizable value or gone concern) assumption. To reflect accounting differences such as these, the proposed scaling approach scales available capital in addition to the capital requirement. Scaling from bank capital rules to insurance capital rules is applied to the total of combining common equity tier 1, additional tier 1, and tier 2 capital under the Board's banking capital rule because there is only one tier of capital in the BBA and NAIC RBC.

In the example of a simple insurance depository institution holding company presented in Sections IV.C.2 and IV.D above, the life insurance parent's subsidiary IDI had total capital of \$27 million and RWA of \$150 million. To calculate scaled available capital and required capital, the IDI's amounts under Federal banking capital rules are used in the equations shown above. Specifically, scaled capital requirement =  $0.0106 * \$150\text{ million} = \$1.59\text{ million}$  and scaled available capital =  $\$27\text{ million} - (0.063 * \$150\text{ million}) = \$27\text{ million} - \$9.45\text{ million} = \$17.55\text{ million}$ .<sup>62</sup>

A further illustration of this step in applying the BBA is presented in Section IX.F.

### D. Approach Where Scalars Are Not Specified

As proposed, the BBA only includes scaling between Federal bank capital rules and NAIC RBC. However,

<sup>61</sup> The notion of the "total balance sheet perspective" refers to the idea that an accounting framework affects valuations of assets, liabilities, and equity, and thus can affect calculation of required and available capital. From this standpoint, scaling required capital without also considering whether available capital needs to be scaled can result in an incomplete depiction of a company's capital position.

<sup>62</sup> The amounts in the example in Section IV.D above are rounded for convenience.

depending on how insurance depository institution holding companies change their structures and business mixes over time, or new insurance depository institution holding companies come under Board supervision, the BBA may need to include scaling from other frameworks. While the Board will not propose scalars for specific capital frameworks not present in the existing population of insurance depository institution holding companies, the proposed BBA includes a framework by which the scaling would be provisionally determined for a capital framework where no scalar is specified, should the need arise.

This provisional approach would be used for a non-U.S. insurance subsidiary when its regulatory capital framework is scalar compatible, as defined in the proposed rule. The proposed rule defines "scalar compatible framework" as (1) a framework for which the Board has determined scalars or (2) a framework that exhibits the following three attributes: (a) The framework is clearly defined and broadly applicable to companies engaged in insurance; (b) the framework has an identifiable intervention point that can be used to calibrate a scalar;<sup>63</sup> and (c) the framework provides a risk-sensitive measure of required capital reflecting material risks to a company's financial strength. Where the non-U.S. insurance subsidiary's regulatory capital framework is not scalar compatible, the BBA proposes to apply U.S. insurance capital rules to the company.

*Question 22: The Board invites comment on the proposed approach to scalars and the associated white paper. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?*

*Question 23: How should the Board develop scalars for international insurance capital frameworks if needed?*

## VI. Determination of Capital Requirements Under the BBA

### A. Capital Requirement for a Building Block

The proposed BBA determines aggregate capital requirements by beginning with the capital requirements at each building block. For building block parents that are subject to NAIC RBC in the BBA, the Board proposes to use the ACL amount of required capital under NAIC RBC as the input to

<sup>63</sup> As used in this Supplementary Information, "intervention point" refers to a threshold for the ratio of available capital to capital requirement at which the relevant regulator may take action against the supervised firm under applicable law.

<sup>60</sup> The Board continues to review insurance depository institution holding companies' operations in non-U.S. jurisdictions and may later propose scaling for non-U.S. insurance capital frameworks, depending on further evaluation of these companies, frameworks, and risk and activities therein.

aggregation. For building block parents subject to the Board's banking capital rule, the Board proposes to use total risk-weighted assets as the input to aggregation. An illustration of this step in applying the BBA is presented in Section IX.D below.

#### *B. Regulatory Adjustments to Building Block Capital Requirements*

The main categories of adjustments to capital requirements under the proposed BBA (the denominator in the BBA ratio) are discussed below.<sup>64</sup>

*Question 24: The Board invites comments on all aspects of the proposed adjustments to capital requirements. Should any of the adjustments be applied differently? What other adjustments should the Board consider?*

An illustration of this step in applying the BBA is presented in Section IX.E.2 below.

#### 1. Adjusting Capital Requirements for Permitted and Prescribed Accounting Practices Under State Laws

The accounting practices for insurance companies can vary from state to state due to permitted and prescribed practices, which can result in significant differences in financial statements between similar companies filing SAP financial statements in different states. Regulators both within and outside of the United States have the authority to take actions with respect to insurance companies in the form of variations from standard accounting practices. An issue for the BBA is whether and how to address international or state regulator-approved variations in accounting or capital requirements for regulated insurance companies.

The proposed BBA contains adjustments to address permitted practices, prescribed practices, or other practices, including legal, regulatory, or accounting, that departs from a capital framework as promulgated for application in a jurisdiction. To serve the Board's supervisory objectives, the Board proposes an adjustment to capital requirements (the denominator in the BBA ratio) to reverse state permitted and prescribed practices (and, where relevant, any approved variations applied by solvency regulators other than U.S. state and territory insurance

supervisors). The Board considers that this proposed adjustment provides for a consistent representation of financial information across all companies in the jurisdiction.

The Board anticipates that the majority of permitted and prescribed practices would primarily affect available capital, but includes the adjustment to capital requirements for completeness and because permitted practices to balance sheet items such as reserves can have secondary impacts on the NAIC RBC calculation. Extensions or other company-specific treatments may also affect capital requirements as calculated under non-U.S. insurance capital frameworks.

#### 2. Certain Intercompany Transactions

Although intercompany transactions are eliminated in consolidated accounting frameworks, in an aggregated framework like the BBA, some intercompany transactions could introduce redundancies in capital requirements or raise the potential to overstate risk at the aggregated, enterprise-wide level. Others could reduce the capital requirement of a company without reducing the overall risk to the institution. The Board considers that some adjustments to capital requirements for intercompany transactions may be appropriate for the BBA. For instance, intra-group reinsurance, loans, or guarantees can result in credit risk weights at the subsidiary level without generating additional risk at the enterprise level. In this scenario, eliminating risk weights in the appropriate companies' capital requirements may better reflect total enterprise-wide risk.

The BBA thus proposes an adjustment for the elimination of charges for the possibility of default of the top-tier depository institution holding company or any subsidiary thereof. However, in many cases, the impact on enterprise-wide capital requirement from this reflection of risk may be small or immaterial. The Board thus proposes to make this adjustment optional, *i.e.*, allowing the insurance depository institution holding company the option to eliminate the credit risk weight in capital requirements at one company party to the intercompany transaction.

#### 3. Adjusting Capital Requirements for Transitional Measures in Applicable Capital Frameworks

Similar to the availability of permitted and prescribed practices and other approved variations, transitional measures are sometimes included under capital frameworks during

implementation.<sup>65</sup> While such measures are important for application of regulatory capital frameworks, in practice, the framework, without applying the transitional measures, can provide a more accurate reflection of risk as intended by that framework. The BBA thus proposes an adjustment to remove the effects of any grandfathering or transitional measures under an applicable capital framework in determining capital requirements. Along with the adjustment for permitted and prescribed practices and other aspects of the rule, this adjustment is anticipated to help increase the comparability of results among supervised firms.

#### 4. Risks of Certain Intermediary Companies

As described in Section IV.C, an insurance depository institution holding company has the option to not treat as an MFE a company that meets the definition of an MFE. Typically, such a company would be one that serves as a pass-through or risk management intermediary for other companies under the insurance depository institution holding company.<sup>66</sup> If an insurance depository institution holding company were to make this election, the risks posed by this company must nonetheless be reflected in the BBA. As proposed, the BBA would require the insurance depository institution holding company to allocate the risks that the company faces to the other companies in the enterprise with which the company engages in transactions.

#### 5. Risks Relating to Title Insurance

For an insurance depository institution holding company predominantly engaged in title insurance, the risks are reflected in part in the company's claim reserve liability, but the Board's banking capital rule would not risk-weight this amount. To determine an appropriate risk weight to apply to this liability, the Board reviewed data from historical title claim reserves and observed a risk comparable to assets that have been assigned a 300 percent risk weight in the Board's banking capital rule. In order to tailor

<sup>65</sup> In the United States insurance market, one prominent impact of this proposed adjustment would be to accelerate the application of principles-based reserving. This adjustment could also encompass transitional measures in Europe, such as the long-term grandfathering of disparate accounting of insurance liabilities, if a jurisdiction in Europe were to become relevant in the application of the BBA.

<sup>66</sup> Frequently a pass-through company like this enters into transactions with affiliates (*e.g.*, operating insurers) and enters into back-to-back transactions with third parties to manage risks on a portfolio basis

<sup>64</sup> The BBA proposes an adjustment to available capital requiring that building block parents deduct the amount of their investments in their own capital instruments along with any investments made by members of their building block, to the extent such instruments are not already excluded from available capital. In the proposed rule, a corresponding adjustment is made in determining building block available capital.

the Board's banking capital rule to an insurance depository institution holding company predominantly engaged in title insurance, the Board proposes to adjust capital requirements by applying a risk weight of 300 percent to the firm's claim reserves relating to title insurance business, as reflected in the firm's U.S. GAAP financial statements.<sup>67</sup>

*Question 1: Is the proposed risk weighting approach for risks relating to title insurance appropriate? For example, would a different risk weight (i.e., a risk weight other than 300 percent) be more appropriate?*

### *C. Scaling and Aggregating Building Blocks' Adjusted Capital Requirements*

In order to bring capital requirements from various frameworks to a comparable basis before aggregation, the BBA would scale capital requirements. Capital requirement amounts for building block parents would be scaled by application of the parameters set out in Section V above.

The BBA aggregates a downstream building block's capital requirements into those of its upstream building block parent by scaling to the upstream parent's capital framework and adding to the upstream parent's capital requirement. This rollup includes adjusting for the parent's ownership of the building block prior to adding in the scaled capital requirement for the building block. In performing this rollup, building blocks are aggregated to achieve a consolidated, enterprise-wide reflection of capital requirements. Ultimately, all building blocks under the top-tier depository institution holding company would be scaled and rolled up into the capital position of the top-tier depository institution holding company.

An illustration of this step in applying the BBA is presented in Section IX.H.

## **VII. Determination of Available Capital Under the BBA**

### *A. Approach to Determining Available Capital*

#### **1. Key Considerations in Determining Available Capital**

A firm's capital resources should be accessible to absorb losses and not have features that cause the firm's financial condition to weaken in times of stress.

<sup>67</sup> A significant asset of typical title insurers is an asset known as the title plant, which, under U.S. GAAP, would be considered an intangible asset (Financial Accounting Standards Board, Accounting Standards Codification Topic 950–350). The Board continues to see the U.S. GAAP treatment as appropriate in applying the Board's banking capital rule to the insurance depository institution holding company predominantly engaged in title insurance.

In developing the BBA the Board was informed by its review of existing capital frameworks—including the NAIC's RBC, the Board's banking capital rules, and their objectives, taking into account, among other things, considerations of the permanence and subordination of capital resources; the right of the issuer to make, cancel, or defer payments under a capital instrument; and the absence of encumbrances.

In many capital frameworks, including the Board's banking capital rule, qualifying capital is divided into tiers. In general, tiers of capital can represent different levels of capital resources' availability and loss-absorbency. Capital in a higher tier may represent the ability to absorb losses such that the institution can continue operations as a going concern, while capital in a lower tier may represent resources that serve as a supplementary cushion to a higher tier and aid the institution in the event of resolution (i.e., a gone/near-gone concern).

By contrast, the state insurance capital framework uses one tier of capital. In the proposed BBA, the frameworks most often applicable to the supervised firms' building blocks will be U.S. state insurance capital frameworks. The NAIC RBC framework began as an early warning system, providing a risk sensitive "safety net" for insurers that provides for timely regulatory intervention in the case of insurer distress or insolvency.<sup>68</sup> Among other things, intervention is based on a comparison of TAC to required capital at ACL. As such, the NAIC RBC framework and TAC, in part through reliance on SAP financial data for their development and implementation, reflect aspects of a "gone concern" or liquidation value standard.<sup>69</sup> Moreover, TAC, as a single tier of capital, is a component of the RBC framework at intervention levels other than ACL.

The proposed BBA contains one tier of available capital. This approach achieves the supervisory objectives sought to be achieved through the BBA in a manner that achieves simplicity of design.

#### **2. Aggregation of Building Blocks' Available Capital**

The Board proposes to determine available capital in the BBA by aggregating available capital under the

frameworks applicable to the companies in an insurance depository institution holding company, subject to certain limited adjustments, rather than applying a consistent definition or set of criteria to all capital instruments for inclusion in the BBA. Since the BBA will determine aggregate capital requirements by beginning with capital requirements from company capital frameworks (prior to adjustments and scaling), determining available capital in a different manner could introduce inconsistencies. Moreover, applying a single set of definitional criteria, as occurs in the Board's banking capital rule, may be facilitated when the subject firms prepare consolidated financial statements in accordance with U.S. GAAP or other rules. However, doing this may be more challenging in the context of differing bases of accounting across building blocks in the BBA applied to insurance depository institution holding companies.

Mechanically, the proposed rule determines available capital under the BBA similarly to how it determines capital requirements, namely, by rolling up available capital from downstream building block parents into upstream building block parents, with certain adjustments and scaling. The aggregation of available capital eliminates double leverage or multiple leverage by deducting upstream parents' investments in subsidiaries that are building block parents.<sup>70</sup>

In addition, the proposal requires an insurance depository institution holding company to deduct upstream holdings within a building block, i.e., an investment by a subsidiary of a building block parent in the building block parent's capital instrument. The purpose of this deduction is to avoid the potential for inflation of a supervised firm's available capital through inter-affiliate transactions, and furthermore, to avoid a potential circularity in the BBA calculation.

<sup>70</sup> In a case of double-leverage, for instance, the parent's investment in subsidiary, replaced by the building block available capital, will continue to have an offsetting liability from the parent's debt issuance. If double-leverage or double-gearing exists within a building block, where the upstream (capital-providing) company and downstream (capital-receiving) company are in the same building block, the double-leverage would not be inflating capital for the building block. If double-leverage occurs with the upstream company in one building block and the downstream in a different building block, the upstream building block parent would deduct its downstreamed capital to the capital-receiving company, thereby avoiding double-counting in the calculation.

<sup>68</sup> See NAIC, Risk-Based Capital, [http://www.naic.org/cipr\\_topics/topic\\_risk\\_based\\_capital.htm](http://www.naic.org/cipr_topics/topic_risk_based_capital.htm).

<sup>69</sup> NAIC, NAIC Group Capital Calculation Recommendation, p. 2 (2015), available at [http://www.naic.org/documents/committees\\_e\\_grp\\_capital\\_wg\\_related\\_cap\\_calc\\_reccomendation.pdf](http://www.naic.org/documents/committees_e_grp_capital_wg_related_cap_calc_reccomendation.pdf).

### *B. Regulatory Adjustments and Deductions to Building Block Available Capital*

This section discusses adjustments in the BBA to determine available capital, performed at the level of each building block. The next section (subsection VII.C below) discusses two final adjustments, made at the level of the top-tier parent once all building block available capital is aggregated.

*Question 25: The Board invites comments on all aspects of the proposed adjustments to available capital. Should any of the adjustments be applied differently? What other adjustments should the Board consider?*

An illustration of adjusting available capital in applying the BBA is presented in Section IX.E.2.

#### 1. Criteria for Qualifying Capital Instruments

Adjustments at the level of determining building block available capital include deducting any capital instrument, issued by a company within the building block that fails one or more of the eleven criteria for Tier 2 capital under the Board's banking capital rule, as codified in section 217.20(d) of the Board's Regulation Q.<sup>71</sup> While the current population of insurance depository institution holding companies has relatively less publicly issued capital or debt instruments compared to stock companies, the Board considers it appropriate to set these criteria to reflect the Board's supervisory goals and objectives, ensure adequate loss absorbency of available capital under the BBA with a measure of consistency, and take into account the possibility of changes to the population of insurance depository institution holding companies. The criteria apply a measure of consistency to capital instruments for inclusion as available capital under the BBA. Depending on their characteristics, capital instruments allowable as available capital under company-level capital frameworks may also satisfy these criteria, thereby qualifying under the BBA.

*Question 26: What other criteria, if any, should the Board consider for determining available capital under the BBA?*

*Question 27: One of the criteria, concerning capital instruments that contain certain call features, requires the top-tier depository institution holding company to obtain prior Board approval before exercising the call option. Should the Board apply a de*

*minimis threshold below which this approval is not needed?*

The Board proposes that certain instruments frequently used by insurers, surplus notes,<sup>72</sup> could be eligible for inclusion in available capital under the BBA, provided that the notes meet the criteria to qualify as capital under the BBA. Treatment of surplus notes under state insurance capital framework remains unaltered by the BBA. Moreover, it appears reasonable to conclude that issuers of surplus notes may or may not have contemplated all of the criteria for available capital under the BBA when issuing surplus notes that are presently outstanding.

The Board is thus proposing to include a grandfathering provision for surplus notes issued by a top-tier depository institution holding company or its subsidiary to a non-affiliate prior to November 1, 2019. This allows existing and currently planned surplus notes to qualify without any modifications, but future surplus notes would be expected to comply with all requirements after a short notice period. Under this grandfathering, these notes are deemed to meet criteria set out in proposed Section 608(a) that they may not otherwise meet, provided that the surplus note is currently capital under state insurance capital frameworks (a company capital element as set out in the proposed rule) for the issuing company.

*Question 28: Are there other approaches, other than grandfathering, that the Board should consider to address surplus notes issued by insurance depository institution holding companies or their subsidiaries before November 1, 2019?*

*Question 29: What grandfathering date should the Board use?*

Certain instruments used as capital resources may have call options that could be exercised within five years of the issuance of the instrument, specifically for a "rating event." The Board proposes section 217.608(f) in the BBA to accommodate these capital resources.

<sup>72</sup> Surplus notes generally are financial instruments issued by insurance companies that are included in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations, and typically have the following features: (1) The applicable state insurance regulator approves in advance the form and content of the note; (2) the instrument is subordinated to policyholders, to claimant and beneficiary claims, and to all other classes of creditors other than surplus note holders; and (3) the applicable state insurance regulator is required to approve in advance any interest payments and principal repayments on the instrument.

#### 2. BBA Treatment of Deduction of Insurance Underwriting Risk Capital

As set out above, under application of the proposed BBA, certain capital-regulated companies, including IDIs and other companies subject to the Federal bank capital rules, would be identified as building block parents. In applying the Board's banking capital rule to determine available capital, one deduction from qualifying capital relates to the deduction of the amount of the capital requirement for insurance underwriting risks established by the regulator of any insurance underwriting activities of the bank, including such activities of a subsidiary of the bank. In the context of the BBA, an aggregation-based framework that is structurally and conceptually different from the Board's banking capital rule, the risk-sensitive amount of required capital is aggregated into the enterprise-wide capital requirement. Measuring enterprise-wide risk based on insurance underwriting activities is among the core supervisory objectives that the BBA serves. Deducting capital requirements for insurance underwriting activities, when aggregate capital requirements will reflect this risk, could overly penalize an insurance depository institution holding company.

The Board's banking capital rule deducts, for a depository institution holding company insurance subsidiary, the RBC for underwriting risk from qualifying capital (and assets subject to risk weighting). In the BBA, this deduction would be eliminated in calculating building block available capital since the insurance risks are being aggregated, rather than deducted.

#### 3. Adjusting Available Capital for Permitted and Prescribed Practices Under State Laws

As explained above in section VI with regard to capital requirements, the accounting practices for insurance companies can vary from U.S. state to state due to permitted and prescribed practices, and can result in significant differences in financial statements between companies with similar financial profiles but domiciled in different states. An issue for the BBA is whether and how to address regulator-approved variations in determining available capital. Similar to the adjustment described above to the calculation of building block capital requirements (the denominator of the calculation), the Board proposes to include adjustments to available capital (the numerator in the BBA ratio) to reverse the impact of these accounting

<sup>71</sup> The criteria are listed in Section 608(a) of the proposed rule.

practices, as well as any other approved variation as proposed in the BBA.<sup>73</sup>

#### 4. Adjusting Available Capital for Transitional Measures in Applicable Capital Frameworks

As with the corresponding adjustment in determining capital requirements under the BBA, similar to the availability of permitted and prescribed practices or other approved variations, transitional measures are sometimes adopted in capital frameworks during implementation. While such measures are important for application of regulatory capital frameworks, in practice, the framework without applying the transitional measures can provide a more accurate reflection of loss absorbing capital as intended by that framework. The BBA thus proposes an adjustment for the removal of the effects of any grandfathering or transitional measures, under a regulatory capital framework, in determining available capital.

#### 5. Deduction of Investments in Own Capital Instruments

To avoid the double-counting of available capital, and in light of the Board's supervisory objectives in designing the BBA, the proposal requires building block parents to deduct the amount of their investments in their own capital instruments along with any such investments made by members of their building block, to the extent such instruments are not already excluded from available capital. In addition, under the proposal, a capital instrument issued by a company in an insurance depository institution holding company's enterprise that the firm could be contractually obligated to purchase also would have been deducted from capital elements. The proposal notes that if an insurance depository institution holding company has already deducted its investment in its own capital instruments from its available capital, it would not need to make such deductions twice.

The proposed rule requires an insurance depository institution holding company to look through its holdings of an index to deduct investments in its own capital instruments, including synthetic exposures related to investments in own capital instruments. Gross long positions in investments in its own capital instruments resulting from holdings of index securities would have been netted against short positions

in the same underlying index. Short positions in indexes to hedge long cash or synthetic positions could have been decomposed to recognize the hedge. More specifically, the portion of the index composed of the same underlying exposure that is being hedged could have been used to offset the long position only if both the exposure being hedged and the short position in the index were covered positions under the market risk rule and the hedge was deemed effective by the banking organization's internal control processes which would have been assessed by the primary federal supervisor of the banking organization or is reported as a highly effective hedge by insurance supervisors under Statement of Statutory Accounting Principle 86. If the insurance depository institution holding company found it operationally burdensome to estimate the investment amount of an index holding, the proposal permits the institution to use a conservative estimate with prior approval from the Board. In all other cases, gross long positions would be allowed to be deducted net of short positions in the same underlying instrument only if the short positions involved no counterparty risk. In determining such net long positions, the proposed BBA would exclude such positions held in a separate account asset or through an associated guarantee, unless the relevant separate account fund is concentrated in the company.

#### 6. Reciprocal Cross-Holdings in Capital of Financial Institutions

A reciprocal cross-holding results from a formal or informal arrangement between two financial institutions to swap, exchange, or otherwise hold or intend to hold each other's capital instruments. The use of reciprocal cross-holdings of capital instruments to artificially inflate the capital positions of each of the financial institutions involved would undermine the purpose of available capital, potentially affecting the safety and soundness of such financial institutions. Under the proposal, in light of the Board's supervisory objectives in designing the BBA, reciprocal cross-holdings of capital instruments of companies in an insurance depository institution holding company's enterprise are deducted from available capital. The proposed deduction encompasses reciprocal cross-holdings between building block parents and companies external to the insurance depository institution holding company, and such holdings between building block parents and other companies within the insurance

depository institution holding company's enterprise.

#### C. Limit on Certain Capital Instruments in Available Capital Under the BBA

In light of the Board's supervisory objectives in designing the BBA, the Board proposes to limit available capital under the BBA arising from investments in the capital of unconsolidated financial institutions. This treatment is consistent with the Board's banking capital rule and treatment of non-insurance SLHCs under the Board's rules. The proposed BBA incorporates the limit on investments in the capital of unconsolidated financial institutions in the manner currently done under the Board's banking capital rule.

To operationalize this limitation in the context of the BBA, a proxy for consolidation is also needed because the U.S. GAAP definition is not presently applicable to the full population of current insurance depository institution holding companies. The proposed BBA would not treat a company appearing on the insurance depository institution holding company's inventory as an unconsolidated financial institution. Moreover, investments in the capital of unconsolidated financial institutions would be determined as the net long position calculated in accordance with 12 CFR 217.22(h), provided that separate account assets or associated guarantees would not be regarded as an indirect exposure. As a result, the look-through treatment under 12 CFR 217.22(h) would not be applied to separate account assets or associated guarantees.

As noted above, the proposed BBA contains one tier of available capital, but as discussed in this Section VII.C, certain limitations may apply. The criteria set out in subsection VII.B.1 set a baseline threshold for capital instruments to be includable as available capital under the BBA. However, certain more stringent criteria for capital instruments can isolate instruments that are more loss absorbing and of higher quality. These criteria are reflected in the Board's banking capital rule corresponding to capital instruments includable as common equity tier 1 capital, as codified in section 217.20(b) of the Board's Regulation Q.<sup>74</sup>

Consistent with the Board's supervisory objectives, the Board aims to ensure that an insurance depository institution holding company does not

<sup>73</sup> In the proposed BBA, this refers to a permitted practice, prescribed practice, or other practice, including legal, regulatory, or accounting, that departs from a solvency framework as promulgated for application in a jurisdiction.

<sup>74</sup> As noted in the proposed rule, two technical adjustments are proposed to adapt language under the Board's banking capital rule to the appropriate counterpart(s) in the BBA.

hold capital largely using capital instruments of lower quality or loss absorbing capability. In order to ensure that the majority of an insurance depository institution holding company's available capital consists of instruments meeting the criteria in this subsection VI.C, the proposed BBA would limit, at the level of building block available capital for the top-tier parent, capital instruments meeting the criteria in subsection VII.B.1, but not meeting the criteria in 12 CFR 217.20(b), as modified in the proposed BBA (tier 2 capital instruments), to be no more than 62.5 percent of the building block capital requirement for that top-tier parent.

In reaching this proposal, the Board considered expressing this limit as a percentage of the top-tier parent's building block available capital excluding capital instruments qualifying for inclusion in the BBA but not meeting the criteria in 12 CFR 217.20(b), as modified in the proposed BBA. Ignoring any impact of scaling, in light of the Board's supervisory objectives in designing the BBA, this percentage of such available capital could be determined in the context of the minimum capital requirements under the Board's banking capital rule. The Board considered that a limit expressed in this manner was less favorable from a supervisory standpoint. In times of stress, in the Board's supervisory experience, available capital typically declines more rapidly than required capital. As a result, in such times, a supervised firm's capacity to count existing or newly issued tier 2 capital instruments towards regulatory requirements generally would decline in tandem if they were limited as a percentage of other available capital. By contrast, expressing the limit as a percentage of capital requirement avoids much of this procyclicality. Supervised firms would also have a less volatile limit under which to count or issue tier 2 capital instruments in a case where the firm's capital levels fell close to or below the required minimum amounts.

*Question 30: What alternate formulations of the limit on tier 2 capital may be more appropriate, while still ensuring appropriate quality of capital?*

*Question 31: Aside from a limit on tier 2 capital instruments, are there other ways to ensure sufficiently loss absorbing available capital and/or prevent an institution from relying disproportionately on capital resources that are less loss absorbing?*

As discussed below, the minimum capital requirement under the BBA is

for the top-tier parent to hold building block available capital at least equal to 250 percent of its building block capital requirement. In light of the Board's supervisory objectives in designing the BBA, this minimum requirement corresponds to, and is therefore at least as stringent as, the minimum requirement under the Board's banking capital rule of 8 percent of risk-weighted assets. In light of the BBA's limit on tier 2 capital instruments (62.5 percent of the top-tier parent's building block capital requirement), an insurance depository institution holding company holding exactly the minimum requirement level of available capital therefore holds at least 187.5 percent of the top-tier parent's building block capital requirement through available capital *other* than tier 2 instruments (*e.g.*, instruments satisfying the criteria for common equity tier 1 capital, retained earnings, other elements of statutory surplus, etc.). This firm would therefore have this latter form of capital sufficient to cross a threshold of 6 percent of risk-weighted assets, in the context of the Board's banking capital rule.<sup>75</sup>

Thus, the BBA's proposed limitation on tier 2 instruments means that insurance depository institution holding companies would effectively meet the requirements under the Board's banking capital rule applicable to additional tier 1 capital plus common equity tier 1 capital using building block available capital excluding tier 2 instruments.<sup>76</sup> The Board considers that applying the proposed limit on tier 2 instruments achieves a simpler, more tractable application of minimum capital requirements under the BBA without introducing implementation costs outweighing these benefits. In addition, this approach facilitates the Board's use of only one tier of capital in the BBA.

<sup>75</sup> Said differently, if the firm's available capital is distributed 187.5/250, or three-fourths, as resources other than tier 2 instruments, this available capital would, in the context of the Board's banking capital rule, amount to three-fourths of the minimum requirement, or 6 percent of risk-weighted assets. The firm's tier 2 capital, held in the amount of 62.5 percent of the top-tier parent's building block capital requirement, would be one-fourth of available capital at the minimum requirement under the Board's banking capital rule, corresponding to 2 percent of risk-weighted assets in the context of the Board's banking capital rule.

<sup>76</sup> The BBA, as proposed, does not reflect or utilize the criteria for additional tier 1 capital under the Board's banking capital rule. However, in the Board's supervisory experience, the incidence of insurers utilizing capital instruments that meet the criteria of additional tier 1, but not the criteria of common equity tier 1 is not common, and when utilized, does not frequently represent a material proportion of the insurer's capital.

As a simple illustration of these limits, consider further the example presented in Sections IV and V above. Suppose the life insurance parent did not hold any investment in the capital of unconsolidated financial institutions, but had issued \$35 million in surplus notes owned by third parties. Suppose further that these surplus notes qualify for inclusion as available capital under the BBA, but are not grandfathered surplus notes. The life insurance parent's capital requirement of \$99.6 million would be used to determine the limit on surplus notes and other tier 2 instruments that are includable as available capital. Here, the insurance depository institution holding company could not include more than \$62.25 million of tier 2 instruments in available capital,<sup>77</sup> and as a result, the firm can include all of its external-facing surplus notes in available capital. A more fulsome illustration of this step in applying the BBA is presented in Section IX.G below.

#### *D. Board Approval of Capital Elements*

The BBA proposal also includes a provision concerning Board approval of a capital instrument. In accordance with the proposal, existing capital instruments will be includable in available capital under the BBA. However, over time, capital instruments that are equivalent in quality and capacity to absorb losses to existing instruments may be created to satisfy different market needs. Proposed section 217.608(g) accommodates such instruments for inclusion in available capital. Similar authority exists under the Board's banking capital rule under section 217.20(e).<sup>78</sup> In exercising its authority under proposed section 217.608(g), the Board expects to consider, among other things, the requirements for capital elements in the final rule; the size, complexity, risk profile, and scope of operations of the insurance depository institution holding company, and whether any public benefits in approving the instrument would be outweighed by risk to an IDI. Capital instruments already approved under the authority under the Board's banking capital rule remain eligible for inclusion as available capital under the BBA in accordance with this proposal. For purposes of the BBA, proposed section 217.608(g) would apply going forward.

<sup>77</sup> This amount is calculated as \$99.6 \* 62.5%.

<sup>78</sup> Proposed section 12 CFR 217.601(d)(1)(ii) parallels the existing section 12 CFR 217.1(d)(2)(ii).

### VIII. The BBA Ratio, Minimum Capital Requirement and Capital Conservation Buffer

#### A. The BBA Ratio and Proposed Minimum Requirement

Under the BBA, the Board's minimum capital requirement for an insurance

depository institution holding company would be the ratio of aggregated building block available capital to the aggregated building block capital requirement (the BBA ratio):

$$\text{BBA Ratio} = \frac{\text{Building block available capital}}{\text{Building block capital requirement}}$$

In light of the Board's supervisory objectives and authorities in accordance with U.S. law, the Board proposes to require a minimum BBA ratio of 250 percent. The Board determined this minimum threshold by first translating the minimum total capital requirement of 8 percent of risk-weighted assets under the Board's banking capital rule to its equivalent under NAIC RBC. The Board then added a margin of safety to account for factors including any potential data or model parameter uncertainty in determining scaling parameters and an adequate degree of confidence in the stringency of the requirement. The Board notes that the proposed minimum ratio, 250 percent, aligns with the midpoint between two prominent, existing state insurance supervisory intervention points, the "company action level" and "trend test level" under state insurance RBC requirements.<sup>79</sup>

*Question 32: The Board invites comment on the proposed minimum capital requirement. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?*

As a simple illustration of this minimum requirement, consider the example presented in Sections IV, V, and VII above. After aggregating the subsidiary building block parents, the life insurance top-tier parent had building block available capital of \$487.5 million and building block capital requirement of \$99.6 million. Its BBA ratio is thus 489 percent, above the required minimum 250 percent. A further illustration of this step in applying the BBA is presented in Section IX.H.

#### B. Proposed Capital Conservation Buffer

To encourage better capital conservation by supervised firms and enhance the resiliency of the financial system, the proposed rule would limit capital distributions and discretionary

bonus payments for insurance depository institution holding companies that do not hold a specified amount of available capital at the level of a top-tier parent or other depository institution holding company, in addition to the amount that is necessary to meet the minimum risk-based capital requirement proposed under the BBA. Insurance depository institution holding companies would be subject only to the proposed capital conservation buffer under the BBA, not the existing capital conservation buffer codified at section 217.11 of the Board's banking capital rule.

To determine the appropriate threshold for a capital conservation buffer under the BBA, the Board took a similar approach to how it determined the minimum requirement. The analysis began with the threshold levels from the buffer under the Board's banking capital rule and translated them to their equivalents under NAIC RBC.<sup>80</sup> The full amount of the buffer under the Board's banking capital rule, 2.5 percent, translates to 235 percent under the NAIC RBC framework. This translated buffer threshold was applied in the BBA. An insurance depository institution holding company would need to hold a capital conservation buffer in an amount greater than 235 percent (which, together with the minimum requirement of 250 percent, results in a total requirement of at least 485 percent) to avoid limitations on capital distributions and discretionary bonus payments to executive officers. The proposal further provides for a maximum dollar amount (calculated as a maximum payout ratio multiplied by eligible retained income, as discussed below) that the insurance depository institution holding company could pay out in the form of capital distributions or discretionary bonus payments during

the current calendar year. Under the proposal, an insurance depository institution holding company with a buffer of more than 235 percent would not be subject to a maximum payout amount pursuant to the above-referenced proposed provision; however, the Board would retain the ability to restrict capital distributions under other authorities and limitations on distributions under other regulatory frameworks would continue to apply.

In order to tailor the capital conservation buffer to the insurance business, the proposal introduces a number of technical adaptations to the capital conservation buffer appearing in the Board's banking capital rule to apply this in the context of an insurance depository institution holding company. First, in light of the proposed annual reporting cycle for the BBA, discussed below, the proposed rule would apply the capital conservation buffer on a calendar year basis rather than quarterly. Second, the proposed rule broadens "distributions" to include discretionary dividends on participating insurance policies because, for mutual insurance companies, these payments are the equivalent of stock dividends. Third, rather than restrict the composition of the capital conservation buffer to solely common equity tier 1 capital, the proposal restricts the composition to building block available capital excluding tier 2 instruments. Moreover, the proposed rule replaces the thresholds appearing in 12 CFR 217.11, Table 1, with corresponding amounts that have been scaled from the Board's banking capital rule to the common capital framework under the BBA.<sup>81</sup>

In addition, the proposal defines "eligible retained income" as "the annual change in building block available capital," excluding certain changes resulting from capital markets

<sup>79</sup> See footnote 16 for explanation of company action level and trend-test level as used in the context of RBC.

<sup>80</sup> Because the thresholds here are part of a capital conservation buffer, which is inherently a provision to apply an added margin of safety, no uplift or margin of safety was built into the intervention points after translating those under the Board's banking capital rule to NAIC RBC.

<sup>81</sup> Note that, as defined in the proposed rule, tier 2 capital instruments are those meeting the criteria for tier 2 capital under the Board's banking capital rule, but failing the criteria for common equity tier 1 capital.



transactions. This change significantly reduces operational burden because, unlike in the bank context, insurance depository institution holding companies do not necessarily calculate a consolidated retained earnings amount that could serve as the basis upon which to apply the definition of “eligible retained income” without modification.

*Question 33: The Board invites comment on the proposed minimum capital buffer. What are the advantages and disadvantages of the buffer? What is the burden associated with the buffer?*

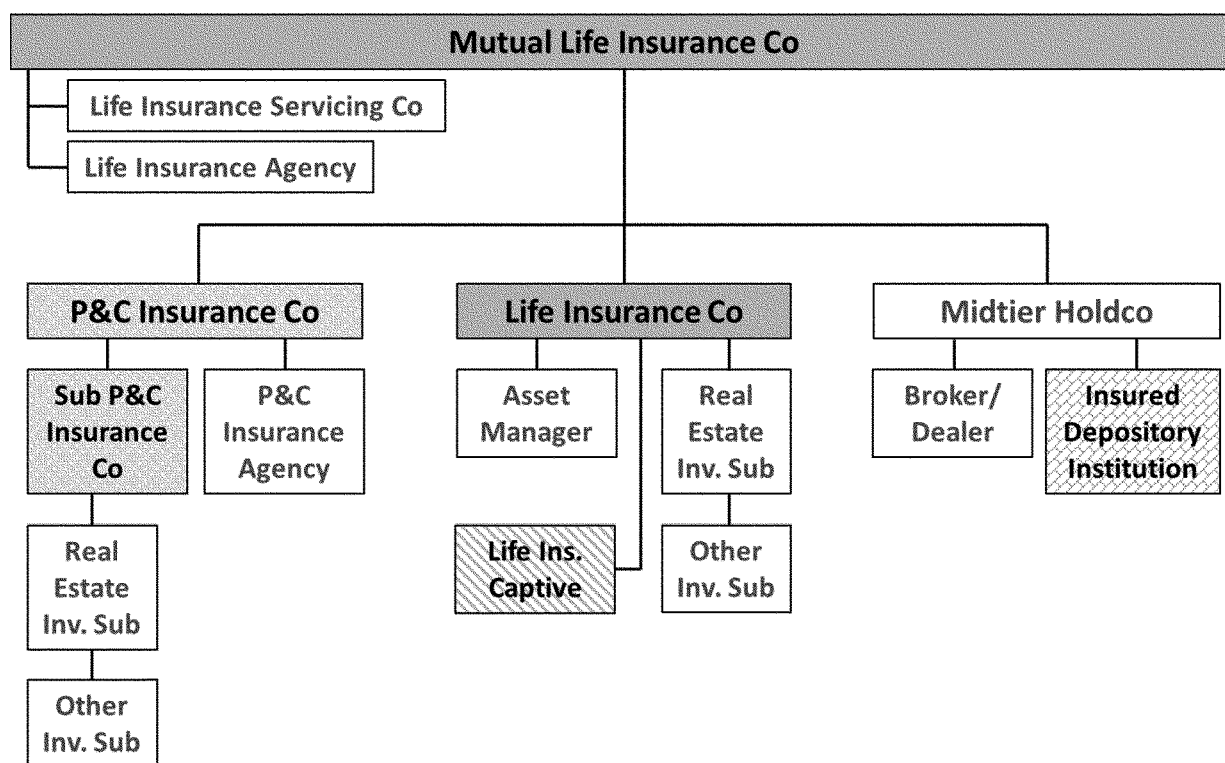
### IX. Sample BBA Calculation

In order to better illustrate the steps and application of the BBA, this NPR presents the example below based on a fictitious mutual life insurance company.

#### A. Inventory

As described above in Section IV.C.1, the first step in applying the BBA is identifying an inventory of companies within the insurance depository institution holding company's enterprise. This would generally be

performed by identifying the companies on the Board's Y-10 and Y-6 forms together with companies on the Schedule Y, as prepared in accordance with the NAIC's SSAP No. 25, included in the most recent statutory annual statement for an operating insurer in the insurance depository institution holding company's enterprise. The organizational chart below illustrates the application of this step for the sample insurance firm presented here, Mutual Life Insurance Company (Mutual Life).



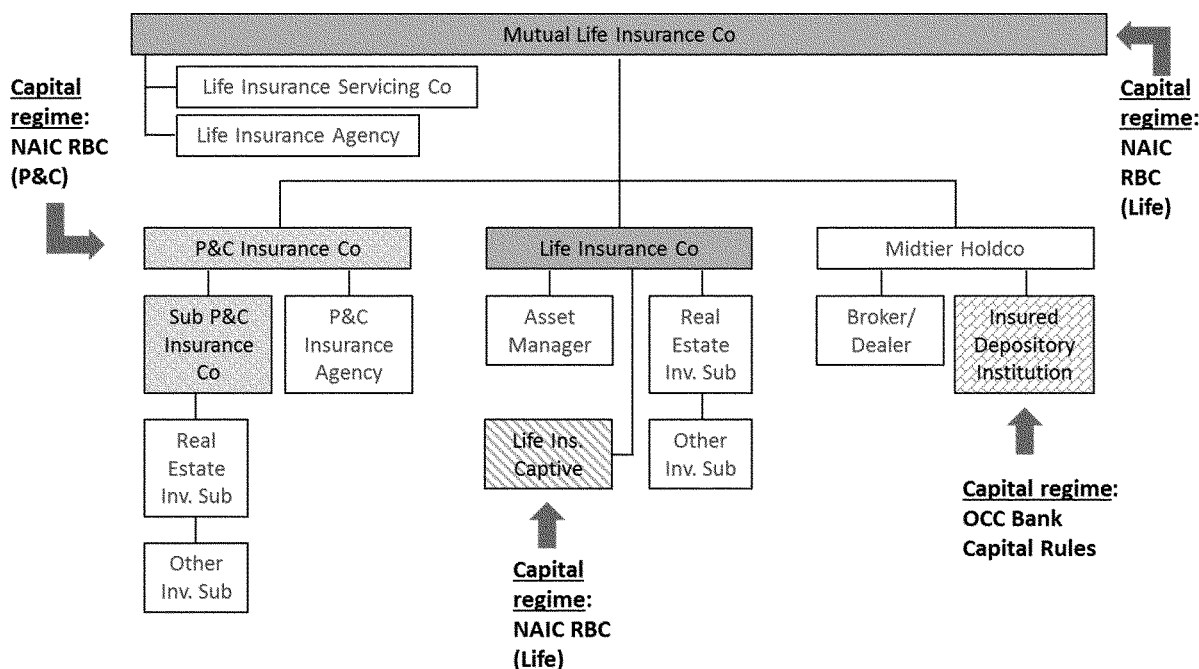
As can be seen from this organizational chart, Mutual Life Ins. Co. is the top-tier depository institution holding company of the insurance depository institution holding company's enterprise. In addition to two life insurance companies, this enterprise has two P&C insurance companies, a life captive insurance company, and an IDI (assume it is a nationally-chartered IDI), as well as a number of nonbank, non-insurance companies, including life and P&C insurance agencies, investment vehicles, an asset manager, a broker/

dealer, and a midtier holding company above the IDI.

#### B. Applicable Capital Frameworks

As described in Section IV.C.2, the second step in applying the BBA is to determine the applicable capital frameworks for companies under the insurance depository institution holding company. As proposed in this rule, the applicable capital framework for a company other than one engaged in insurance or reinsurance underwriting, except for an IDI, is the Board's banking

capital rule, while the applicable capital framework for a nationally-chartered IDI is the banking capital rule as set forth by the OCC. For companies engaged in insurance or reinsurance underwriting, the applicable capital framework is generally the regulatory capital framework under the laws or regulations to which that company is subject. The applicable capital frameworks for companies under Mutual Life Ins. Co. are presented below.



In the illustration above, the applicable capital frameworks are shown for certain key companies. For instance, the applicable capital frameworks for Mutual Life Insurance Co., the top-tier depository institution holding company, and P&C Insurance Co. are shown, but no frameworks are shown for Life Insurance Agency or P&C Insurance Agency—these two companies would be treated as they are under the capital frameworks applicable to their immediate parents. Assume that the life insurance captive was material in relation to the insurance depository institution holding company through Mutual Life Insurance Company guaranteeing the return on certain investments of the captive. The life insurance captive would be treated as an MFE and the applicable capital framework would be the NAIC's RBC applicable to life insurance companies.

### C. Identification of Building Block Parents and Building Blocks

As described in Section IV.C.3, the third step in applying the BBA is to identify the building block parents. Most often, this will occur as a result of having identified the applicable capital frameworks for the companies under the insurance depository institution holding

company, where a capital-regulated company or MFE is assigned to a building block when its applicable capital framework differs from that of the next-upstream capital-regulated company, MFE, or DI holding company.

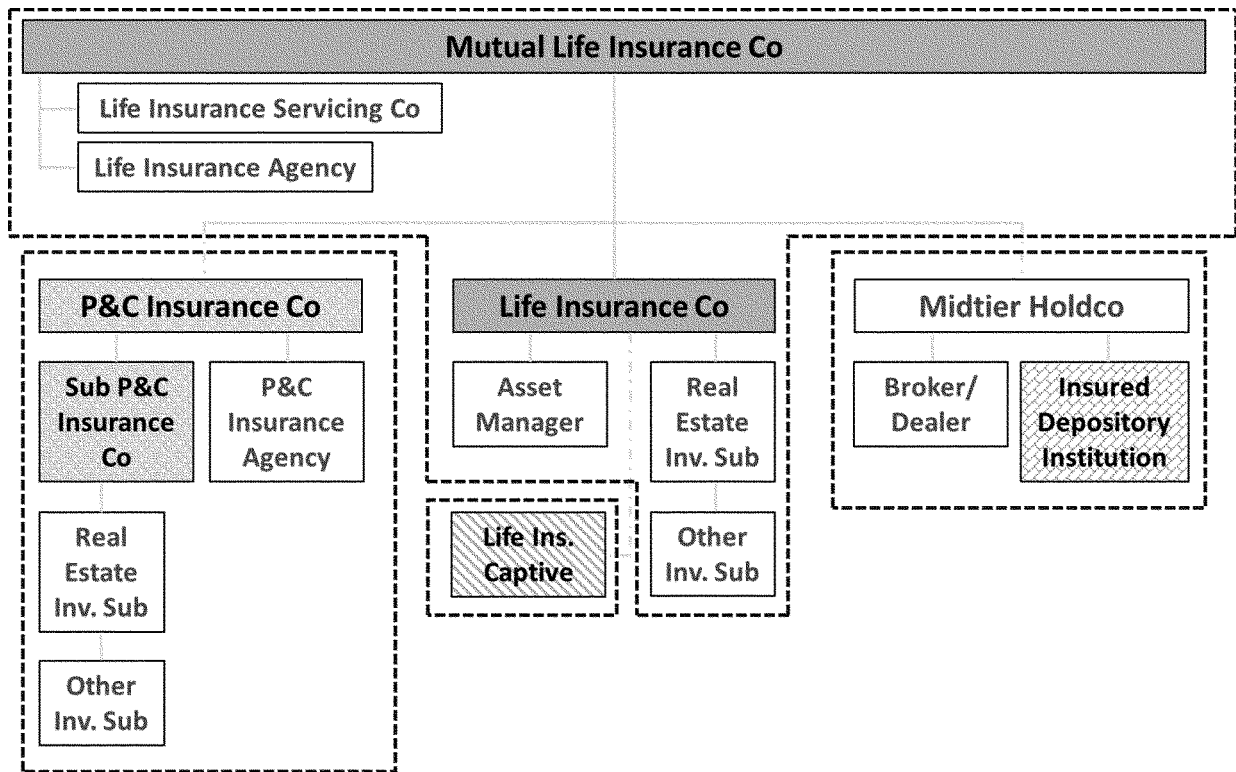
As the top-tier depository institution holding company, Mutual Life Insurance Company itself is the first candidate to be a building block parent. Life Insurance Co. would fall under the same applicable capital framework as the top-tier depository institution holding company (NAIC life RBC), and therefore would not be identified as a building block parent; rather, it would remain in the same building block as the block for which Mutual Life Ins. Co. is building block parent. By contrast, the BBA proposes (for purposes of identification of building blocks) to treat NAIC RBC for life and P&C as distinct frameworks; thus, P&C Insurance Company is identified as a building block parent from Mutual Life Ins. Co. With it, the Subsidiary P&C Insurance Company, P&C Insurance Agency, and two investment subsidiaries would be members of this building block.

The life insurance captive would be subject to NAIC RBC for life insurers. Because treatment of captives' risk can vary among insurers, the life insurance

captive may not be reflected in the RBC capital calculations of its operating insurance parents. Assuming that, for purposes of this illustration, the life insurance captive's risk is not reflected in the RBC calculations of Mutual Life or Life Ins. Co., the captive would be made its own building block parent. The other subsidiaries of Life Insurance Co. would be assigned to the building block for which Mutual Life Ins. Co. is building block parent.

Midtier Holdco is a depository institution holding company. Under the proposed rule, this company would be identified as a building block parent. Note that, as a non-insurance company, this company's applicable capital framework under the proposed BBA would be the Board's banking capital rule, which, in turn, would reflect the risks of the IDI. Therefore, the IDI would not be identified as a building block parent. The same would be the case for the broker/dealer, which, together with the IDI, would be assigned as a member of Midtier Holdco's building block.

Thus, the building block parents in Mutual Life Ins. Co.'s enterprise are Mutual Life Ins. Co., P&C Ins. Co., Life Ins. Captive, and Midtier Holdco. The demarcation of building blocks for Mutual Life Ins. Co. is shown below:

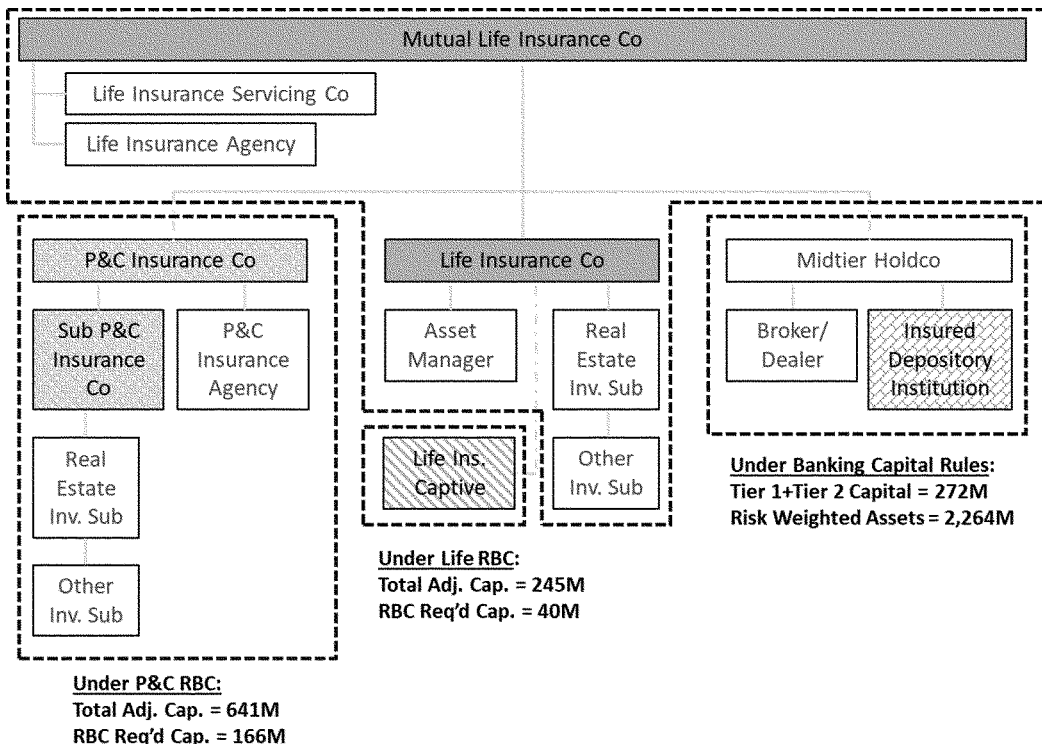


*D. Identification of Available Capital and Capital Requirements Under Applicable Capital Frameworks*

Assume that, for the captive, an RBC calculation is performed and reported to

the state regulator even though the captive generally would not be subject to the same generally applicable capital requirements as primary insurers. Assume further that, for Mutual Life Ins. Co., the available capital and capital

requirement amounts for its four building blocks are as shown below. Determination of available capital and capital requirements would result as follows:



### E. Adjustments to Available Capital and Capital Requirements

#### 1. Illustration of Adjustments to Capital Requirements

As described in Section VI.B above, the BBA, as proposed, includes a number of possible adjustments to capital requirements at the level of each building block. Assume that no adjustments to capital requirements are applicable in the building block for which Mutual Life Insurance Company is the building block parent.

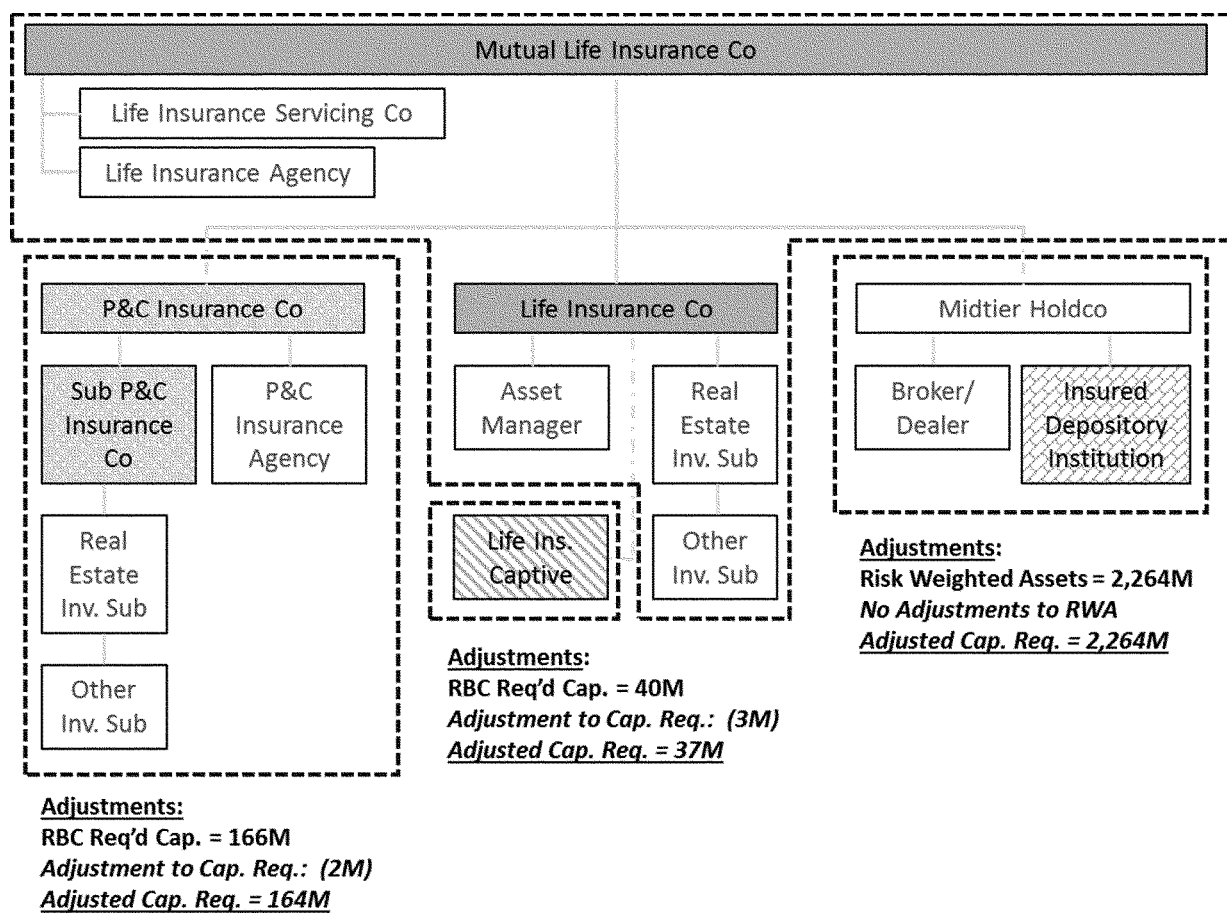
The first possible adjustment is to reverse any permitted or prescribed practices that affect capital requirements. Suppose that the Life Ins. Captive benefits from a prescribed practice under its domiciliary jurisdiction, specifically, that assets in the form of conditional letters of credit are reported on the balance sheet without corresponding liabilities. This prescribed practice would be adjusted out of the capital requirement. Under the proposed BBA, these letters of credit would not be treated as assets and,

hence, would face no risk weight. Additionally, the use of principles-based reserving from the elimination of transitional measures would impact the RBC calculation because reserves are used in different parts of the RBC calculation, including the calculation of exposure to mortality risk. Assume that the total impact on Life Insurance Company's RBC capital requirement from these adjustments to captives is \$3 million.

The second possible adjustment to capital requirements is an optional elimination of intercompany credit risk weights. Suppose that in Mutual Life Ins. Co., there is an inter-affiliate reinsurance arrangement whereby P&C Ins. Co. reinsures a portion of Sub P&C Ins. Co.'s book. Sub P&C Ins. Co. retains some risk, and faces a charge in its RBC requirement for its receivables from its parent. Suppose that this receivable is in the amount of \$40 million, the RBC charge for Sub P&C Ins. Co. is \$2 million, and Mutual Life Ins. Co. elects to make this adjustment.

An additional possible adjustment to capital requirements relates to the insurance depository institution holding company's ability to elect to not treat as an MFE a company that otherwise meets the definition of this term, after which the insurance depository institution holding company must correspondingly allocate the risks of this company to other companies in the insurance depository institution holding company with which the company engages in transactions. Assume that Mutual Life Ins. Co. has no companies other than its Life Insurance Captive that would constitute MFEs and that Mutual Life Ins. Co. opts to treat the Life Insurance Captive as an MFE. This adjustment to capital requirements is therefore not applicable in this case.

Under the BBA as proposed, no adjustments would take place to total risk-weighted assets for building block parents subject to the Board's banking capital rule. Thus, the total impact of adjustments to capital requirements for Mutual Life Ins. Co. can be shown as follows:



## 2. Illustration of Adjustments to Available Capital

As described in Section VII.B above, the proposed BBA includes a number of possible adjustments to available capital. In the example of Mutual Life Ins. Co., assume that no adjustments to available capital are applicable in the building block for which Mutual Life Insurance Company is the building block parent.

However, suppose that the P&C Insurance Co. subsidiary benefits from a permitted practice under its domiciliary jurisdiction. As described in Section VII.B.3, permitted and prescribed practices would be adjusted out of available capital, so that insurance companies are presented on a consistent basis in the BBA. Suppose that, for P&C Insurance Co., the increase to surplus arising from the permitted practice is \$15 million. This amount would be

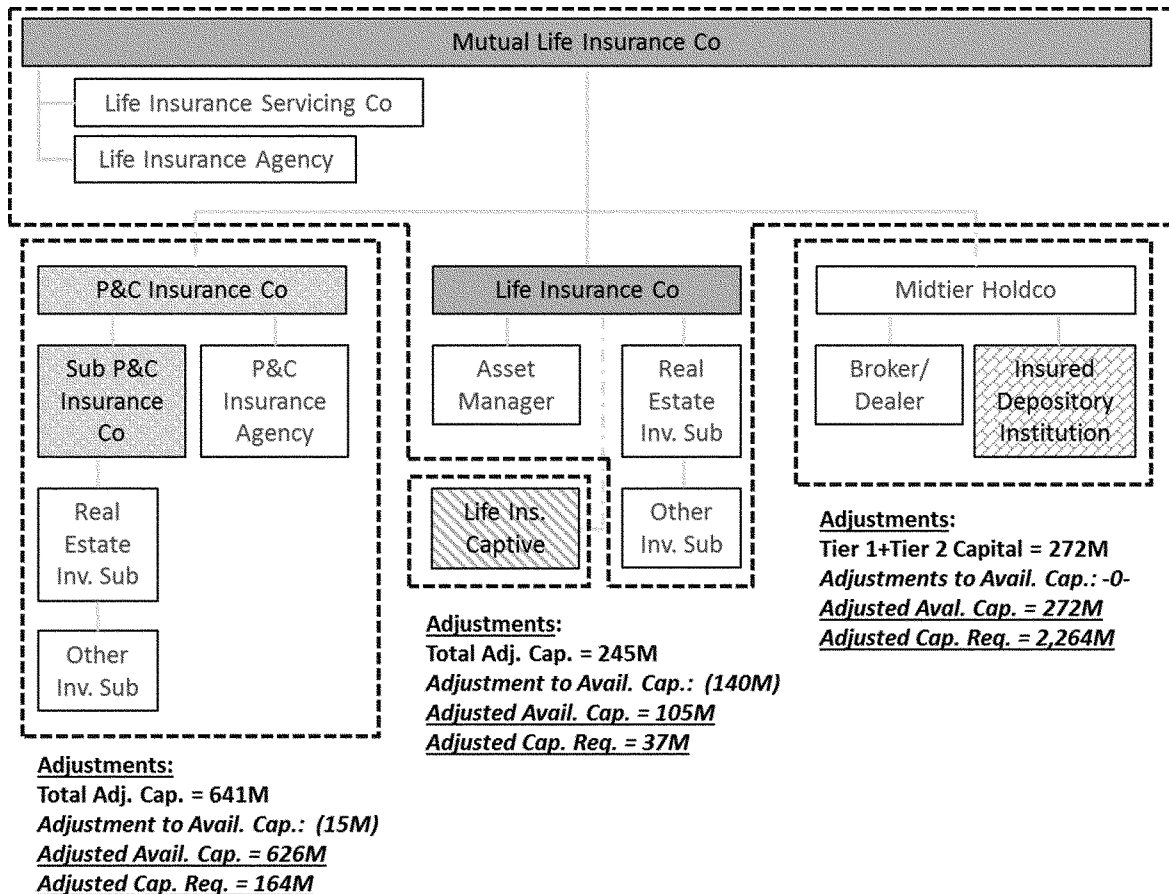
deducted in determining building block available capital for P&C Insurance Co.

Captive reinsurers typically would have at least two related adjustments. Suppose that, as noted above, the Life Ins. Captive has a prescribed practice that allows holding undrawn contingent letters of credit as assets without a corresponding liability. By application of the adjustment to available capital to reverse prescribed practices, described in Section VII.B.3, these letters of credit would not be treated as assets and, hence, would not contribute to available capital under the proposed BBA. Suppose that, for Life Ins. Captive, these letters of credit are held at \$240 million. This amount would be deducted in determining building block available capital for Life Ins. Captive. Somewhat offsetting this, captives would typically benefit from the adjustment that removes transitional measures. Suppose that application of principles-based

reserving to business in the captive results in reduced liabilities that increase surplus by \$100 million. This would be added to available capital.

Under the BBA, as proposed, the sole possible adjustment to building block parents, or their building blocks, subject to the Board's banking capital rule arises where the building block parent owns an insurer. Under the Board's banking capital rule, this ownership generally results in a deduction from qualifying capital in the amount of the insurance subsidiary's capital requirement for insurance underwriting risks.<sup>82</sup> In the case of Mutual Life Ins. Co., neither the Midtier Holdco nor IDI have insurance underwriting subsidiaries, so no adjustment is needed to available capital for this building block.

The total impact of adjustments to available capital for Mutual Life Ins. Co. can be shown as follows:



## F. Scaling Adjusted Available Capital and Capital Requirements

As described above in Section V, adjusted available capital and adjusted capital requirement for each building

block are scaled, using the scaling approach proposed by the Board, to the applicable capital framework of the building block parent most immediately upstream. No scaling is proposed for

translating between NAIC RBC as applicable to life and P&C insurance. Thus, in the case of Mutual Life Ins. Co., for the building blocks for which P&C Ins. Co. and Life Ins. Captive are

<sup>82</sup> See 12 CFR 217.22(b)(3).

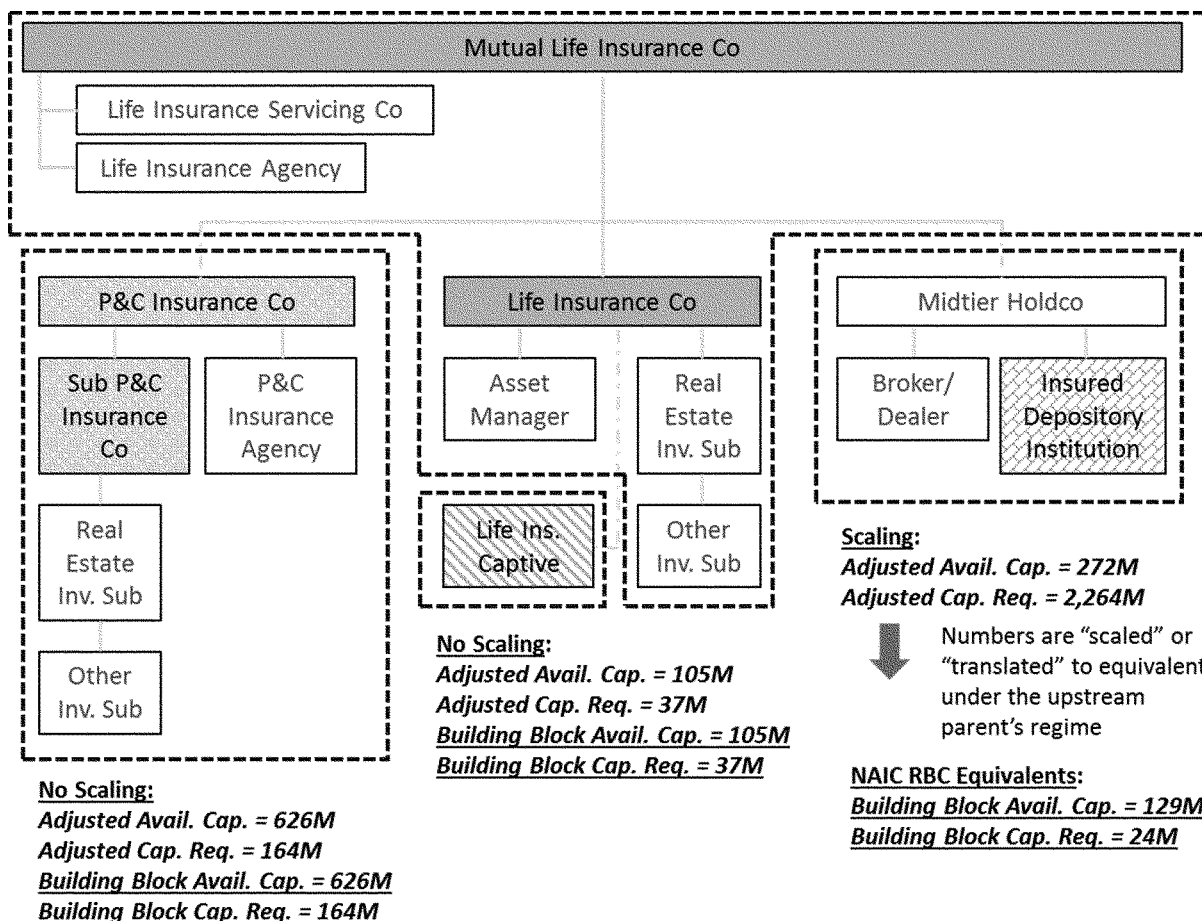
building block parents, no scaling is needed to translate to NAIC RBC as applied to Mutual Life Ins. Co. For these building blocks, the building block available capital are the adjusted available capital amounts and the building block capital requirements are the adjusted capital requirements.

For the building block for which Midtier Holdco is building block parent, scaling is needed. This building block is under the Board's banking capital rule. The building block parent most immediately upstream, Mutual Life Ins. Co., is under NAIC RBC. Thus, scaling is needed between the Board's banking capital rule and NAIC RBC according to

the equations set out in Section V.C above. The calculations are as follows:

$$\begin{aligned}\text{Building block available capital} &= \$272\text{M} - (\$2,264\text{M} * 6.3\%) = \$129\text{ million} \\ \text{Building block capital requirements} &= \$2,264\text{M} * 1.06\% = \$24\text{ million}\end{aligned}$$

The total impact of scaling for Mutual Life Ins. Co. can be shown as follows:



#### G. Roll-Up and Aggregation of Building Blocks

As described in Sections IV.D, VI.C, and VII.A.2 above, building block available capital and building block capital requirement, reflecting adjustments and scaling, are rolled up through successive upstream building blocks until the top-tier parent's building block is reached.

At each step, when rolling up available capital, any downstreamed capital from the upstream parent is deducted. Assume that Mutual Life Ins. Co. provides no capital to P&C Ins. Co. or Midtier Holdco other than its equity investment in the subsidiary, and that Mutual Life Ins. Co. carries these subsidiaries at \$698 million and \$301 million, respectively. Assume that Mutual Life Ins. Co. treats the Life Ins.

Captive as a nonadmitted asset. The total impact on Mutual Life Ins. Co.'s surplus is thus \$999 million, which would be deducted in the roll-up prior to re-aggregating the building block available capital for P&C Ins. Co., Midtier Holdco, and Life Ins. Captive.

When rolling up capital requirements, the amount of the upstream parent's capital requirement attributable to each downstream building block parent is deducted. Mutual Life Ins. Co.'s RBC required capital amount would include the unadjusted P&C RBC requirement for P&C Ins. Co., assumed to be \$166 million, in its C0 component, but would include no amount attributable to Life Ins. Captive. Mutual Life Ins. Co.'s holding of Midtier Holdco would affect its life RBC calculation through the C1cs component, deriving from the carrying

value of \$301 million but also may reflect the impact of asset concentration charges, taxes, and the covariance adjustment as reflected in the life RBC calculation. Assume that extracting Midtier Holdco from Mutual Life Ins. Co.'s RBC calculation would reduce the amount (on the basis of the authorized control level of RBC) by \$24 million. Assume that the total impact on Mutual Life Ins. Co.'s RBC requirement is thus \$190 million, which would be deducted in the roll-up prior to re-aggregating the building block capital requirement for P&C Ins. Co., Life Ins. Captive, and Midtier Holdco.

In each case, the roll-up is also done taking into account the upstream parent's allocation share of the downstream building block parent. For purposes of Mutual Life Ins. Co., assume

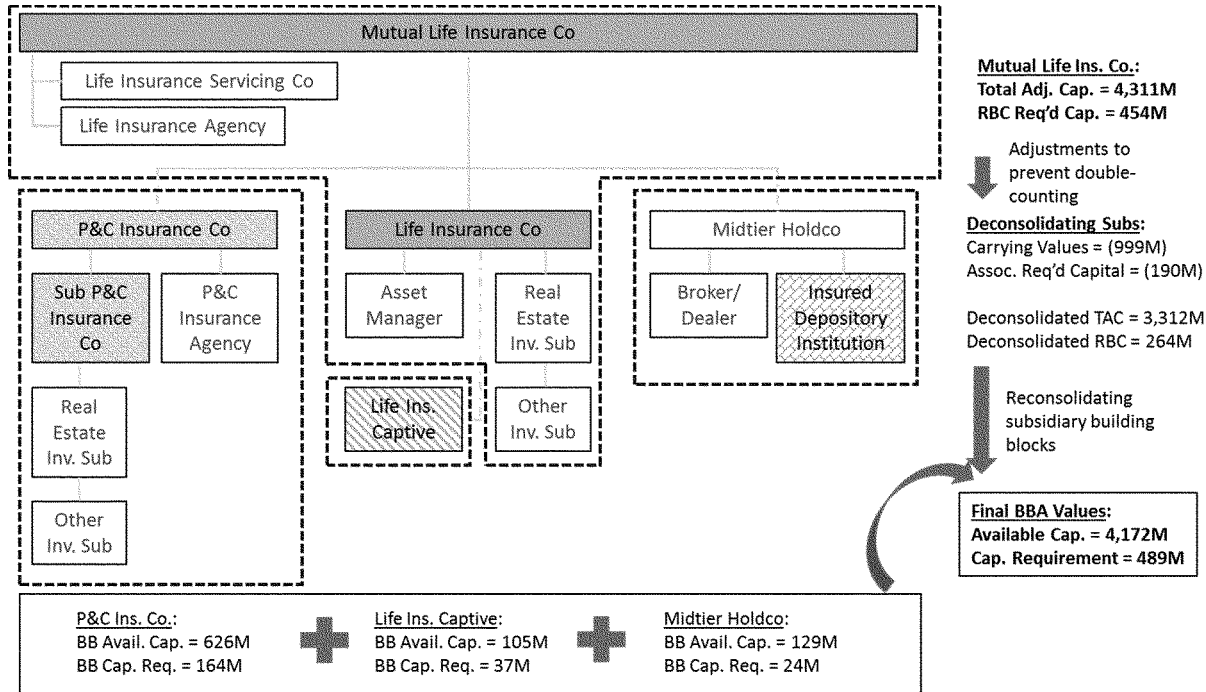
all subsidiaries are wholly owned, so that all allocation shares are 100 percent.

Taking into account the building block available capital amounts, building block capital requirements, and deductions of downstreamed capital

and contributions to Mutual Life Ins. Co.'s RBC related to P&C Ins. Co., Life Ins. Captive, and Midtier Holdco, the resulting building block available capital and building block capital requirement amounts for Mutual Life Ins. Co. are as follows:

Building block available capital = \$4,311 + (999) + 626 + 105 + 129 = \$4,172 million  
 Building block capital requirement = \$454 + (190) + 164 + 37 + 24 = \$489 million

This can be shown as follows:



As described in Section VII.C above, there is a remaining adjustment at the level of the top-tier depository institution holding company to determine whether capital instruments that meet the criteria set out in Section VII.B.1 above, but not the criteria in Section VII.C, exceed 62.5 percent of capital requirements. Assume that Mutual Life Ins. Co. has outstanding surplus notes that are grandfathered as proposed in the BBA, and thus are deemed to satisfy the criteria set out in Section VII.B.1 above. These surplus notes may not meet the criteria set out in Section VII.C above, but as proposed in the BBA, would be grandfathered

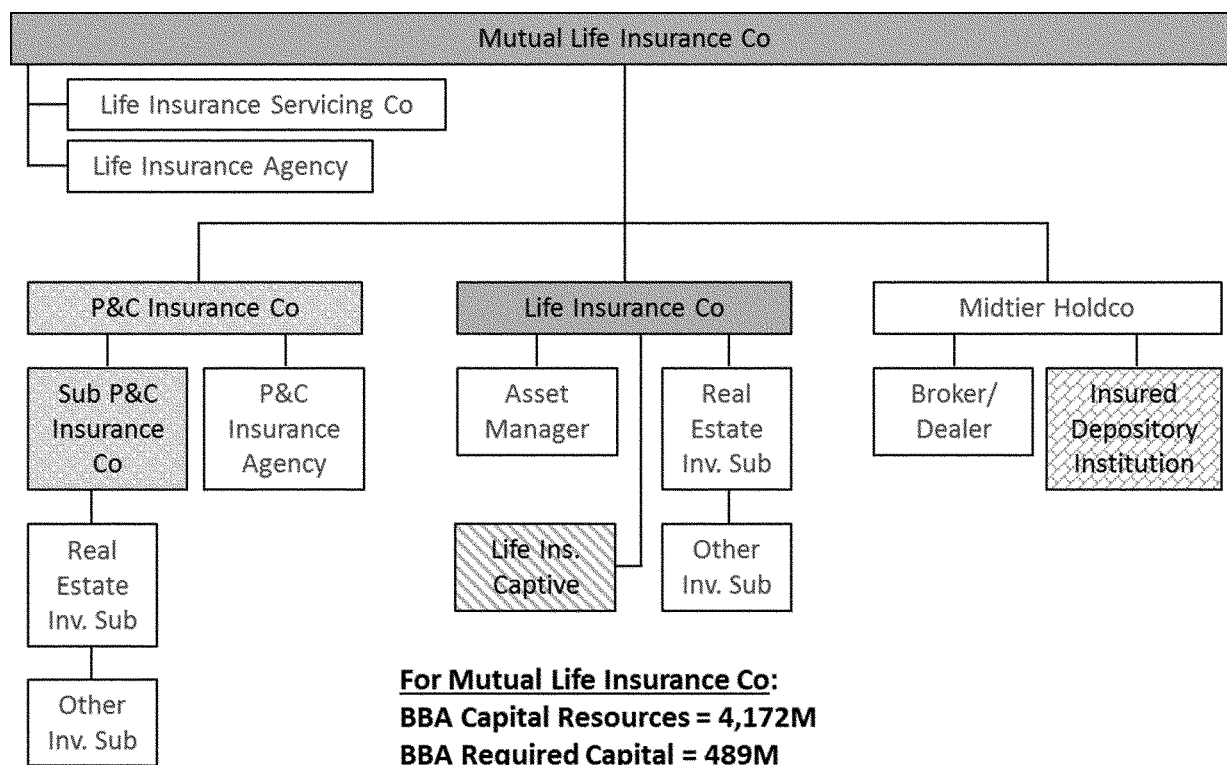
such that the BBA would not limit the insurance depository institution holding company from treating all of these instruments as available capital under the BBA. Going forward, the unretired portion of these surplus notes would continue to be grandfathered, and Mutual Life Ins. Co. would treat as available capital any instruments meeting the criteria from Section VII.B.1, but not meeting the criteria in Section VII.C, not exceeding the greater of 62.5 percent of capital requirements and the outstanding grandfathered surplus notes.

#### H. Calculation of BBA Ratio and Application of Minimum Requirement and Buffer

As described in Sections III.A above, the ratio of building block available capital to building block capital requirements is the calculated BBA Ratio. This ratio is reviewed relative to the minimum requirement set out in the proposed BBA. In the example presented above, the ratio of building block available capital to building block capital requirements for Mutual Life Ins. Co. is \$4,172 million/\$489 million = 853 percent. This can be shown as follows:

BILLING CODE 6210-01-P





**BBA Ratio = 853%**

**BILLING CODE 6210-01-C**

Relative to the minimum capital requirement proposed in the BBA, 250 percent, and the 235 percent buffer atop this minimum, Mutual Life Ins. Co. would be considered to have met the minimum requirement and buffer with a BBA ratio of 853 percent.

**X. Reporting Form and Disclosure Requirements**

In connection with this proposed rule, the Board proposes to implement a new reporting form for use in the BBA. The proposed reporting form, titled "Capital Requirements for Board-Regulated Institutions Significantly Engaged in Insurance Activities" (Form FR Q-1), and instructions focus on information needed to carry out the BBA calculations.<sup>83</sup> The proposed Form FR Q-1 is not intended to be exhaustive in terms of addressing supervisory needs other than the needs for the BBA.

The vast majority of the information reported to the Board through the proposed reporting form would not be public. The information that the Board proposes to make public would consist of the building block available capital, building block capital requirement, and BBA ratio for the top-tier parent of an

insurance depository institution holding company's enterprise. The Board has long supported meaningful public disclosure by supervised firms with the objective of improving market discipline and encouraging sound risk management practices. The Board is also aware that a sizable amount of information is publicly disclosed by insurance firms pursuant to state laws and that IDIs disclose their Call Reports. At this stage, the Board does not see the need for the proposed BBA to require more detailed disclosure of information by an insurance depository institution holding company. The Board's consideration of market discipline is also informed by the fact that the current population of insurance depository institution holding companies represents a minority of the U.S. insurance market. Furthermore, the Board believes that the proposed disclosure requirements strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.<sup>84</sup> The Board

<sup>83</sup> Proprietary information encompasses information that, if shared with competitors, would render a supervised firm's investment in these products/systems less valuable, and, hence, could undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship.

has tailored the proposed disclosure requirements under the BBA so as to enable insurance depository institution holding companies to provide the disclosures without revealing proprietary and confidential information.

As set out in the proposed reporting form and instructions, the form would be sent to the Board annually by March 15 of each year. The Board may also choose to require reporting more frequently than annually if needed for the Board to fulfill its supervisory objectives. Instances calling for such more frequent reporting may include, among others, a significant change such that the most recent reported amounts are no longer reflective of the supervised firm's capital adequacy and risk profile, or a significant change in qualitative attributes (for example, the firm's risk management objectives and policies, nature of reporting system, and definitions).

*Question 34: What should the Board consider in determining the reporting cycle for the BBA?*

*Question 35: Aside from what is currently proposed for public disclosure under the BBA and associated reporting form, should additional information submitted to the Board pursuant to the BBA be made public?*

<sup>83</sup> The proposed Form FR Q-1 and instructions are available at <https://www.federalreserve.gov/apps/reportforms/review.aspx>.

To be transparent, gather additional input, and provide a valuable test of the proposed approach, the Board intends to conduct a quantitative impact study (QIS) of the BBA as part of its rulemaking process. The data collected through this QIS will be used to analyze the impact of various aspects of the proposed BBA. For instance, information collected through the QIS will allow further exploration of areas of thought and concern raised by commenters in response to the Board's ANPR of June 2016. In addition, the Board's analysis of the QIS results may inform its advocacy of positions in international insurance standard setting, including an aggregation method, akin to the BBA, that may be deemed comparable to the ICS. The analysis of QIS results may also assist in the Board's continued engagement with the NAIC and the NAIC's development of the GCC so as to minimize burden and achieve efficiencies with regard to firms that may be subject to more than one of these approaches.

## **XI. Impact Assessment of Proposed Rule**

This section presents a preliminary assessment of anticipated benefits and costs of the proposed BBA, were it to be adopted as proposed. The Board's review of potential costs and benefits of this proposal remains ongoing as the Board proceeds towards a final rule implementing the BBA. This assessment will be informed by a QIS. Furthermore, the Board remains mindful of the assistance commenters can provide in bringing to light anticipated costs and benefits. The Board has already reached a more informed preliminary assessment of benefits and costs because of the comments submitted in response to the ANPR. This preliminary analysis indicates that the proposed BBA achieves the statutory requirement to establish a consolidated capital requirement for insurance depository institution holding companies in a manner that streamlines burden such that the benefits should more than outweigh any initial or ongoing implementation costs. The Board invites comments on all potential benefits and costs, as well as balance between the two, arising from the BBA as proposed.

To the greatest extent possible, the Board attempts to minimize regulatory burden in its rulemakings, consistent with the effective implementation of its statutory responsibilities. Moreover, the Board remains committed to transparency in this and all of its rulemaking processes, including engagement with interested parties and

an appropriate balancing of benefits, costs, and economic impacts.

### *A. Analysis of Potential Benefits*

#### **1. A Capital Requirement for the Board's Consolidated Supervision**

One of the main elements of a program of supervision of financial institutions is a robust and risk-sensitive capital requirement, a key benefit provided by the BBA with respect to insurance depository institution holding companies. Maintaining sufficient capital is central to a financial institution's ability to absorb unexpected losses and continue to engage in financial intermediation. Ensuring the adequacy of a supervised firm's capital levels and a robust capital planning process for managing and allocating its capital resources are primary objectives of the Board's consolidated supervision, including supervision of insurance depository institution holding companies. In the absence of a capital rule for insurance depository institution holding companies, the Board's supervision of these firms has focused on the second of these objectives, evaluation of the supervised firms' capital planning. The Federal Reserve System's supervisory teams conduct capital adequacy inspections at insurance depository institution holding companies, evaluating processes and policies for capital planning including methodologies and controls. A more complete supervisory program includes a capital requirement, a need that this proposal aims to fill and a principal benefit it is intended to achieve.

#### **2. Going Concern Safety and Soundness of the Supervised Institution**

With a capital requirement for insurance depository institution holding companies, the Board as a consolidated supervisor will have a risk-sensitive framework to assess going-concern safety and soundness for each insurance depository institution holding company and the population of these firms overall. This enables firm-specific capital adequacy review and horizontal reviews across firms. The Board remains cognizant that state insurance supervisors regulate the types of insurance products offered by insurance companies that are part of organizations that the Board supervises, as well as the manner in which the insurance is provided, and the capital adequacy of licensed insurers. The Board's consolidated supervision is complementary to, and in coordination with, existing legal-entity supervision by the states by providing a perspective

that considers the risks across the entire firm.

As a result, the Board's supervision will have the ability to consider risks at the enterprise level arising from an array of sources, including companies subject and not subject to a capital requirement, and insurance and non-insurance companies, under an insurance depository institution holding company. The BBA therefore has the benefit of not only providing a capital requirement for the Board's consolidated supervision, but also providing the Board with additional supervisory insights.

#### **3. Protection of the Subsidiary Insured Depository Institution**

The Board believes that it is important that any company that owns and operates a depository institution be held to appropriate standards of capitalization. The Board's consolidated supervision of an insurance depository institution holding company encompasses the parent company and its subsidiaries, and allows the Board to understand the organization's structure, activities, resources, and risks, and to address financial, managerial, operational, or other deficiencies before they pose a danger to the insurance depository institution holding companies' subsidiary depository institutions. Using its authority, the Board proposes a consolidated capital requirement for insurance depository institution holding companies, helping to ensure that these institutions maintain adequate capital to support their group-wide activities and do not endanger the safety and soundness of their depository institution subsidiaries.

The proposed BBA brings the benefit of contributing to the protection of the insurance depository institution holding companies' IDIs and, consequently, the FDIC and the U.S. system of deposit insurance. Deposit insurance has provided a safe and secure place for those households and small businesses with relatively modest amounts of financial assets to hold their transactional and other balances, and Congress designed deposit insurance mainly to protect the modest savings of unsophisticated depositors with limited financial assets.

#### **4. Improved Efficiencies Resulting From Better Capital Management**

The proposed BBA brings the benefit of potential efficiencies at insurance depository institution holding companies through improved capital management practices by providing an enterprise-wide capital requirement and associated framework. For example, the application of a consolidated capital

requirement in the form of the BBA could result in an insurance depository institution holding company discovering that its aggregate, enterprise-wide capital position is different than previously estimated, resulting in the insurance depository institution holding company being able to manage and allocate its capital in a way that more accurately reflects its risks. If insurance depository institution holding companies are better able to manage risk, then over the long term, the proposed rule may result in decreased losses and related costs to insurance depository institution holding companies and their IDIs.

#### 5. Fulfillment of a Statutory Requirement

As noted above, the Board is charged by Congress to promulgate rules in accordance with statutory mandates, which reflect a deliberation of costs and benefits first performed by Congress. The framework proposed in this NPR fulfills a statutory mandate under Section 171 of the Dodd-Frank Act.

#### *B. Analysis of Potential Costs*

##### 1. Initial and Ongoing Costs To Comply

While insurers typically have internal capital planning processes, calculations, and metrics, insurance depository institution holding companies do not presently perform an enterprise-wide capital calculation mandated by a federal regulator. Compliance with the BBA will thus require some upfront setup and attendant maintenance to collect the requisite information, perform the calculations, and submit the required reports, as well as opportunity cost of management's time to undertake this setup. However, the BBA builds on existing legal entity capital requirements and, as a result, minimizes the amount of additional systems infrastructure development beyond what is already done by the insurance depository institution holding company to comply with its entity-level regulatory requirements. Implementation costs are thereby notably less relative to a ground-up capital requirement.

Under the proposal, the BBA would require certain calculations of, and information pertaining to, the RBC requirements for certain operating insurance companies in the insurance depository institution holding company's enterprise. Generally, RBC reports that insurers file with state regulators are confidential under the applicable state laws. The proposed reporting form FR Q-1 aims to reflect this treatment under state law while still

serving the Board's supervisory objectives.

The attributes of the BBA as proposed are not anticipated to give rise to significant initial or ongoing implementation costs. Generally, compliance with the BBA may entail initial costs for an insurance depository institution holding company. In particular, the firm may need to set up certain systems for information collection and processing and, on an ongoing basis, maintain these systems, conduct certain review, and submit the regulatory reports required under the proposal. The analysis suggests that these costs will not be unduly burdensome.

The BBA's proposed approach to grouping an insurance depository institution holding company's legal entities into building blocks is not anticipated to be unduly burdensome. Under the proposal, the insurance depository institution holding company would be required to inventory its legal entities, then review each capital-regulated company and material financial entity and ascertain whether each should be treated as a building block parent. The proposed BBA would use an insurance depository institution holding company's Schedule Y, as prepared in the institution's lead insurer's most recent statutory annual statement, together with its Forms Y-6 and Y-10 prepared for the Board, as the basis for the inventory. By leveraging information that the insurance depository institution holding company already prepares under current regulatory requirements, the proposed BBA would streamline implementation burden. The burden of evaluating each company against the BBA's proposed provisions on determining building block parents is anticipated to be minimal.

The proposed rule also sets out a method and formula for scaling between Federal banking capital rules and NAIC RBC. Implementing this provision entails calculations that are not anticipated to be burdensome.

Under the proposed rule, a material financial entity not engaged in insurance or reinsurance underwriting would be subject to the Board's banking capital rule prior to aggregation, unless the insurance depository institution holding company elects to not treat such a company as an MFE. While the burden of identifying a material financial entity is not expected to be sizable, an insurance depository institution holding company may face some initial implementation costs in preparing financial statement data for MFEs in accordance with U.S. GAAP, to the

extent such data is not already prepared. Were the insurance depository institution holding company to decline to treat any such company as an MFE, the firm would be required to allocate the risks faced by the company to relevant affiliates. However, a financial report for an MFE, or allocation of an MFE's risks to affiliates with which it engages in certain transactions, would build on financial data anticipated to be already captured, thereby minimizing additional implementation burden. The costs associated with initial setup to produce financial statement data for MFEs, or allocating the risks of the MFE to relevant affiliates with any attendant recalculations of required capital amounts, could include, but may not be limited to, the opportunity cost of personnel and management's time to establish and oversee processes to generate this data, and the more direct costs of establishing or improving new management information systems to assure the timely and accurate presentation of information. Ongoing costs in either case may include system maintenance and additional staffing to produce the statements, potentially entailing ongoing payroll costs and the opportunity cost of the time spent operating the systems to produce MFEs' financial data or allocating its risks and potential constraints on flexibility in financial or corporate structure. However, none of these initial and ongoing costs is expected to be substantial.

Under the proposal, an insurance depository institution holding company would be required to conform all permitted and prescribed practices, for any insurer in its enterprise, that depart from statutory accounting treatment as set out by the NAIC. An insurance depository institution holding company would also be required to remove the impact of any transitional measures available under applicable capital frameworks. The initial implementation costs of administering these adjustments are anticipated to be comparable to such ongoing costs since reviewing and making these adjustments would generally be done on an annual basis when performing the BBA's calculations. When permitted or prescribed accounting practices impact capital, surplus and/or net income, they are generally required to be disclosed in statutory annual statements prepared by regulated insurers. The identification of these and the remaining such practices is not anticipated to involve significant time beyond what is incurred by the insurance depository institution holding company in preparing its regulatory

filings for state supervisors. Conforming these accounting practices to the NAIC's SAP, and producing revised accounting and RBC information, may entail some implementation costs. The costs associated with these adjustments are expected to be modest within the context of the organizations and could include, but may not be limited to, the costs to recruit and hire staff, including ongoing payroll and benefits costs, and the costs of development and implementation of management information systems.

Under the proposal, the insurance depository institution holding company would have the option to eliminate credit risk weights on intercompany transactions, including loans, guarantees, reinsurance, and derivatives transactions. Because this adjustment is at the option of the insurance depository institution holding company, the Board considers that the supervised institution would only elect for such adjustments if the benefits outweighed the costs. In any event, the costs associated with running entity-level capital requirements, including RBC, excluding intercompany credit risk weights are expected to be minimal, where such costs could include, but may not be limited to, changes in accounting or management information systems and costs of potentially rerunning certain capital calculations, with any attendant costs to recruit and hire staff, including ongoing payroll and benefits costs, to revise accounting treatment as needed.

## 2. Review of Impacts Resulting From the BBA

Any capital requirement has the potential to influence a subject firm's actions. With regard to the BBA, the Board notes that it is generally less likely for an insurance depository institution holding company to fail an aggregation-based approach if it already meets each of its entity-level regulatory requirements. In concept, this outcome may not always hold after reflecting an aggregation-based approach's adjustments, inclusion of entities not subject to a regulatory capital framework, and the intervention levels used by the supervisor applying the aggregation-based approach. However, based on the Board's preliminary review, the Board does not presently anticipate that any currently supervised insurance depository institution holding company will initially need to raise capital to meet the requirements of the proposed BBA.

In light of the Board's supervisory objectives in designing the BBA, the Board proposes in this NPR to subject capital instruments that may be

included in the BBA to the criteria for tier 2 capital under the Board's banking capital rule. It is possible that, to the extent that a state's criteria for inclusion of capital instruments differs from the criteria in the Board's banking capital rule, instruments that qualify under legal entities' RBC requirements would not qualify under the BBA, which could result in an insurance depository institution holding company incurring costs (e.g., issuance costs and required interest or dividend payments) to raise capital resources meeting requirements under the BBA. However, it is relevant that insurance depository institution holding companies in many cases hold capital, in forms other than instruments that may not meet the criteria for tier 2 capital under the Board's banking capital rule, already sufficient to meet the requirements under the BBA.

Moreover, in order to mitigate any burdens arising from these proposed requirements applicable to capital resources, the Board proposes to grandfather existing surplus notes and treat them as available capital under the BBA, and treat as capital, on a going-forward basis, newly issued surplus notes meeting the criteria set out in the BBA.

The proposed BBA would also deduct any investments that an insurance depository institution holding company has in its own capital instruments, including upstream investments by subsidiaries in parents and any reciprocal cross-holdings in the capital of financial institutions. In the Board's supervisory experience, insurance depository institution holding companies tend to have few such investments, if any. The proposed BBA also includes a limitation on the investment by a top-tier parent or other depository institution holding company in instruments recognized as capital of unconsolidated financial institutions. The Board's supervisory experience suggests that insurance depository institution holding companies do not tend to hold such instruments. The Board therefore anticipates any costs or burden arising from these proposed provisions to be minimal or nonexistent.

Under the proposal, the minimum capital requirement applied under the BBA would be the minimum requirement under the Board's banking capital rule, scaled to the BBA's common capital framework, plus a margin of safety. The proposal further includes the capital conservation buffer requirement under the Board's banking capital rule, tailored and scaled to the BBA's common capital framework. To minimize any burden and tailor the BBA to be an insurance-centric

standard, the Board proposes to use, as the common capital framework for aggregation, the NAIC RBC framework. Based on the Board's preliminary review, the Board does not presently anticipate that any insurance depository institution holding company would immediately fail to meet the proposed BBA's minimum capital requirement or this requirement together with the BBA's proposed capital conservation buffer.

The proposed BBA would limit the inclusion in the BBA of instruments meeting the criteria for tier 2 instruments under the Board's banking capital rule, but not meeting the banking capital rule's criteria for common equity tier 1, to 62.5 percent of required capital after aggregating to the level of the top-tier parent of the insurance depository institution holding company's enterprise. An insurance depository institution holding company may have issued instruments that would qualify as tier 2 capital under the banking capital rule, but would not qualify as common equity tier 1 under the same, exceeding 62.5 percent of required capital. In such a case, absent grandfathering, the firm would not be able to count the instruments in excess of 62.5 percent of required capital towards its BBA requirement.<sup>85</sup> In concept, this could result in an insurance depository institution holding company needing to modify its capital structure to comply with this proposed provision. However, based on the Board's preliminary review, and the current insurance depository institution holding companies' overall capital positions, the Board does not anticipate any substantial burden arising from this limitation. Moreover, the proposed grandfathering of outstanding surplus notes issued by any company within an insurance depository institution holding company's enterprise, with the proposed BBA applying the limit on tier 2 instruments to only newly issued surplus notes, will reduce implementation burden.

This proposal also includes the Section 171 calculation, as described above. The Board continues to deliberate the potential implementation costs of this calculation. In light of this, the Board has proposed two options by which subject DI holding companies can exclude certain insurance subsidiaries.

<sup>85</sup> The supervised insurance institution, including the issuer within its enterprise, would remain able to count such instruments towards any other capital requirements.

### 3. Impact on Premiums and Fees

Any initial and ongoing costs of complying with the standard, if adopted as proposed, could nominally affect the premiums and fees that the insurance depository institution holding companies charge, since insurance products are priced to allow insurers to recover their costs and earn a fair rate of return on their capital. A capital requirement like the BBA, if adopted as proposed, could also affect the cost of capital borne by the insurance depository institution holding company, which in turn could affect premiums and an insurer's borrowing cost. In the long run, costs of providing a policy may be borne by policyholders.

Because the expected costs associated with implementing the proposal, if adopted, are not expected to be substantial within the context of the insurance depository institution holding companies' existing budgets, there is not expected to be a substantial change in the pricing of insurance depository institution holding companies' products resulting from the proposed standards. In addition, because the Board does not presently anticipate that any supervised insurance depository institution holding company will need to initially raise capital to meet the requirements of the BBA, there is not expected to be a substantial change in the cost of capital faced by insurance depository institution holding companies. Moreover, the better identification of risk to the safety and soundness of the consolidated enterprise, as well as the subsidiary IDI, that is expected to result from the proposal may lead to improved efficiencies, fewer losses, and lower costs in the long term, which may offset any effects on premiums of any compliance costs.

### 4. Impact on Financial Intermediation

The possibility of reduced financial intermediation or economic output in the United States related to the proposed BBA appears unlikely. In this regard, the Board recalls that capital requirements under the BBA are taken as they are under the jurisdictional capital frameworks, including NAIC RBC, subject to adjustment and scaling that does not alter the underlying capital charges. As a result, the BBA is not expected to operate to influence insurance depository institution holding companies' aggregate investment allocations among asset classes, or more generally affect insurance depository institution holding companies' role in risk assumption or other financial intermediation.

### C. Assessment of Benefits and Costs

Based on an initial assessment of available information, the benefits of the proposed BBA are expected to outweigh any costs. Most significantly, the intent of the proposed rule is to ensure the safety and soundness of the insurance depository institution holding company and protect the subsidiary IDI, in fulfillment of the Board's statutory mandate. The Board believes this objective would be accomplished, in accordance with the Board's supervisory goals, through the proposed BBA in a manner that is minimally burdensome and appropriately tailored.

*Question 36: The Board invites comment on all aspects of the foregoing evaluation of the costs and benefits of the proposed rule. Are there additional costs or benefits that the Board should consider? Would the magnitude of costs or benefits be different than as described above?*

## XII. Administrative Law Matters

### A. Solicitation of Comments on the Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act (Pub. L. 106–102, 113 Stat. 1338, 1471, 12 U.S.C. 4809) requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board has sought to present the proposed rule in a simple and straightforward manner, and invites comment on the use of plain language.

### B. Paperwork Reduction Act

In connection with the proposed rule, the Board proposes to implement a new reporting form that would constitute a "collection of information" within the meaning of the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3521). In accordance with the requirements of the PRA, the Board may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The OMB control number is 7100–NEW. The Board reviewed the proposed information collection under the authority delegated to the Board by the OMB.

The proposed reporting form is subject to the PRA. The form would be implemented pursuant to section 171 of the Dodd-Frank Act and section 10 of HOLA for insurance depository institution holding companies.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the Board's functions,

including whether the information has practical utility;

(b) The accuracy of the Board's estimate of the burden of the information collections, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments on aspects of this notice that may affect reporting, recordkeeping, or disclosure requirements and burden estimates should be sent to the addresses listed in the **ADDRESSES** section. A copy of the comments may also be submitted to the OMB desk officer: By mail to U.S. Office of Management and Budget, 725 17th Street NW, #10235, Washington, DC 20503 or by facsimile to (202) 395–5806.

### Proposed Information Collection

*Title of Information Collection:* Reporting Form for the Capital Requirements for Board-regulated Institutions Significantly Engaged in Insurance Activities.

*Agency Form Number:* FR Q–1.

*OMB Control Number:* 7100–NEW.

*Frequency of Response:* Annual.

*Affected Public:* Businesses or other for-profit.

*Respondents:* Insurance depository institution holding companies.

*Abstract:* Section 171 of the Dodd-Frank Act requires, and section 10 of the Home Owners' Loan Act authorizes, the Board to implement risk-based capital requirements for depository institution holding companies, including those that are significantly engaged in insurance activities.

*Current Actions:* Pursuant to section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and section 10 of HOLA, the Board is proposing the application of risk-based capital requirements to certain depository institution holding companies. The Board is proposing an aggregation-based approach, the Building Block Approach, that would aggregate capital resources and capital requirements across the different legal entities under an insurance depository institution holding company to calculate consolidated, enterprise-wide

qualifying and required capital. The proposed BBA utilizes, to the greatest extent possible, capital frameworks already in place for the entities in the enterprise of a depository institution holding company significantly engaged in insurance activities and is tailored to the supervised firm's business model, capital structure, and risk profile. The new reporting form FR Q-1 would require a depository institution holding company to produce certain information required for the application of the BBA. The proposed reporting form and instructions are available on the Board's public website at <https://www.federalreserve.gov/apps/reportforms/review.aspx>.

#### Estimated Paperwork Burden

*Estimated number of respondents:* 8.

*Estimated average hours per response:* 40 (Initial set-up 160).

*Estimated annual burden hours:* 1,600 (1,280 for initial set-up and 320 for ongoing compliance).

#### C. Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act<sup>86</sup> (RFA), the Board is publishing an initial regulatory flexibility analysis of the proposed rule. The RFA requires an agency to either provide an initial regulatory flexibility analysis with a proposed rule for which a general notice of proposed rulemaking is required, or certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. Based on its analysis and for the reasons stated below, the Board believes that this proposed rule will not have a significant economic impact on a substantial number of small entities. Nevertheless, the Board is publishing an initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after comments received during the public comment period have been considered.

In accordance with section 171 of the Dodd-Frank Act and section 10 of HOLA, the Board is proposing to adopt subpart J to 12 CFR part 217 (Regulation Q) to establish risk-based capital requirements for insurance depository institution holding companies.<sup>87</sup> An insurance depository institution holding company's aggregate capital requirements generally would be the sum of the capital requirements applicable to the top-tier parent and certain subsidiaries of the insurance depository institution holding company, where the capital requirements for

regulated financial subsidiaries would generally be based on the regulatory capital rules of the subsidiaries' functional regulators—whether a state or foreign insurance regulator for insurance subsidiaries or a Federal banking regulator for IDIs. The BBA would then build upon and aggregate capital resources and requirements across groups of legal entities in the insurance depository institution holding company's enterprise (insurance, non-insurance financial, non-financial, and holding company), subject to adjustments.

Under Small Business Administration (SBA) regulations, the finance and insurance sector includes direct life insurance carriers, direct title insurance carriers, and direct P&C insurance carriers, which generally are considered "small" for the purposes of the RFA if a life insurance carrier or title insurance carrier has assets of \$38.5 million or less or if a P&C insurance carrier has less than 1,500 employees.<sup>88</sup> The Board believes that the finance and insurance sector constitutes a reasonable universe of firms for these purposes because this proposal would only apply to depository institution holding companies significantly engaged in insurance activities, as discussed in the **SUPPLEMENTARY INFORMATION**.

Life insurance companies and title insurance companies that would be subject to the proposed rule all substantially exceed the \$38.5 million asset threshold at which they would be considered a "small entity" under SBA regulations. P&C insurance companies subject to the proposed rule exceed the less than 1,500 employee threshold at which a P&C entity is considered a "small entity" under SBA regulations.

Because the proposed rule is not likely to apply to any life insurance carrier or title insurance carrier with assets of \$38.5 million, or P&C carrier with less than 1,500 employees, if adopted in final form, it is not expected to apply to a substantial number of small entities for purposes of the RFA. The Board does not believe that the proposed rule duplicates, overlaps, or conflicts with any other federal rules. In light of the foregoing, the Board does not believe that the proposed rule, if adopted in final form, would have a significant economic impact on a substantial number of small entities supervised. Nonetheless, the Board seeks comment on whether the proposed rule would impose undue burdens on, or have unintended consequences for, small organizations, and whether there are ways such

potential burdens or consequences could be minimized in a manner consistent with section 171 of the Dodd-Frank Act and section 10 of HOLA.

#### List of Subjects

##### 12 CFR Part 217

Administrative practice and procedure, Banks, Banking, Capital, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Risk, Securities.

##### 12 CFR Part 252

Administrative practice and procedure, Banks, banking, Credit, Federal Reserve System, Holding companies, Investments, Qualified financial contracts, Reporting and recordkeeping requirements, Securities.

#### Authority and Issuance

For the reasons set forth in the preamble, the Board of Governors of the Federal Reserve System proposes to amend chapter II of title 12 of the Code of Federal Regulations as follows:

### **PART 217—CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES, AND STATE MEMBER BANKS (REGULATION Q)**

■ 1. The authority citation for part 217 continues to read as follows:

**Authority:** 12 U.S.C. 248(a), 321–338a, 481–486, 1462a, 1467a, 1818, 1828, 1831n, 1831o, 1831p–1, 1831w, 1835, 1844(b), 1851, 3904, 3906–3909, 4808, 5365, 5368, 5371.

#### Subpart A—General Provisions

■ 2. Section 217.1 is amended by:

■ a. Revising paragraphs (c)(1)(ii) and (iii);

■ b. Redesignating paragraphs (c)(2) through (5) as paragraphs (c)(3) through (6); and

■ c. Adding new paragraph (c)(2).

The revisions and additions read as follows:

#### **§ 217.1 Purpose, applicability, reservations of authority, and timing.**

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(ii) A bank holding company domiciled in the United States that is not subject to the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (part 225, appendix C of this chapter), provided that the Board may by order apply any or all of this part to any bank holding company, based on the institution's size, level of complexity,

<sup>86</sup> 5 U.S.C. 601 *et seq.*

<sup>87</sup> See 12 U.S.C. 1467a and 5371.

<sup>88</sup> 13 CFR 121.201.

risk profile, scope of operations, or financial condition; or

(iii) A covered savings and loan holding company domiciled in the United States that is not subject to the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (part 225, appendix C of this chapter). For purposes of compliance with the capital adequacy requirements and calculations in this part, savings and loan holding companies that do not file the FR Y-9C should follow the instructions to the FR Y-9C.

(2) *Insurance Savings and Loan Holding Companies.* (i) In the case of a covered savings and loan holding company that does not calculate consolidated capital requirements under subpart B of this part because it is a state regulated insurer, subpart B of this part applies to a savings and loan holding company that is a subsidiary of such covered savings and loan holding company, provided:

(A) The subsidiary savings and loan holding company is an insurance SLHC mid-tier holding company; and

(B) The subsidiary savings and loan holding company's assets and liabilities are not consolidated with those of a savings and loan holding company that controls the subsidiary for purposes of determining the parent savings and loan holding company's capital requirements and capital ratios under subparts B through F of this part.

(ii) *Insurance savings and loan holding companies and treatment of subsidiary state regulated insurers, regulated foreign subsidiaries and regulated foreign affiliates.*

(A) In complying with the capital adequacy requirements of this part (except for the requirements and calculations of subpart J of this part), including any determination of applicability under § 217.100 or § 217.201, an insurance savings and loan holding company, or an insurance SLHC mid-tier holding company, may elect to:

#### Option 1: Deduction

(1) Not consolidate the assets and liabilities of its subsidiary state-regulated insurers, regulated foreign subsidiaries and regulated foreign affiliates; and

(2) Deduct the aggregate amount of its outstanding equity investment, including retained earnings, in such subsidiaries and affiliates.

#### Option 2: Risk-Weight

(1) Not consolidate the assets and liabilities of its subsidiary state-regulated insurers, regulated foreign

subsidiaries and regulated foreign affiliates;

(2) Include in the risk-weighted assets of the Board-regulated institution the aggregate amount of its outstanding equity investment, including retained earnings, in such subsidiaries and affiliates and assign to these assets a 400 percent risk weight in accordance with § 217.52.

(B) *Nonconsolidation election for state regulated insurers, regulated foreign subsidiaries and regulated foreign affiliates.* (1) An insurance savings and loan holding company or insurance SLHC mid-tier holding company may elect not to consolidate the assets and liabilities of all of its subsidiary state regulated insurers, regulated foreign subsidiaries and regulated foreign affiliates by indicating that it has made this election on the applicable regulatory report, filed by the insurance savings and loan holding company or insurance SLHC mid-tier holding company for the first reporting period in which it is an insurance savings and loan holding company or insurance SLHC mid-tier holding company.

(2) An insurance savings and loan holding company or insurance SLHC mid-tier holding company that has not made an effective election pursuant to paragraph (C)(2)(B)(1) of this section, or that seeks to change its election due to a change in control, business combination, or other legitimate business purpose, may do so only with the prior approval of the Board, effective as of the reporting date of the first reporting period after the period in which the Board approves the election, or such other date specified in the approval.

\* \* \* \* \*

#### ■ 3. In § 217.2,

■ a. Revising the definition of “*Covered savings and loan holding company*, ” and

■ b. Adding the definitions of “*Capacity as a regulated insurance entity*”, “*Insurance savings and loan holding company*”, “*Insurance SLHC mid-tier holding company*”, “*Regulated foreign subsidiary and regulated foreign affiliate*”, and “*State regulated insurer*”.

The revision and additions read as follows:

#### § 217.2 Definitions.

\* \* \* \* \*

*Capacity as a regulated insurance entity* has the meaning in section 171(a)(7) of the Dodd-Frank Act (12 U.S.C. 5371(a)(7)).

\* \* \* \* \*

*Covered savings and loan holding company* means a top-tier savings and loan holding company other than:

(1) An institution that meets the requirements of section 10(c)(9)(C) of HOLA (12 U.S.C. 1467a(c)(9)(C)); and

(2) As of June 30 of the previous calendar year, derived 50 percent or more of its total consolidated assets or 50 percent of its total revenues on an enterprise-wide basis (as calculated under GAAP) from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).

\* \* \* \* \*

*Insurance savings and loan holding company* means:

(1) A top-tier savings and loan holding company that is an insurance underwriting company; or

(2)(i) A top-tier savings and loan holding company that, as of June 30 of the previous calendar year, held 25 percent or more of its total consolidated assets in subsidiaries that are insurance underwriting companies (other than assets associated with insurance underwriting for credit risk); and

(ii) For purposes of this definition, the company must calculate its total consolidated assets in accordance with GAAP, or if the company does not calculate its total consolidated assets under GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board.

*Insurance SLHC mid-tier holding company* means a savings and loan holding company domiciled in the United States that:

(1) Is a subsidiary of an insurance savings and loan holding company to which subpart J applies; and

(2) Is not an insurance underwriting company that is subject to state-law capital requirements.

*Regulated foreign subsidiary and regulated foreign affiliate* has the meaning in section 171(a)(6) of the Dodd-Frank Act (12 U.S.C. 5371(a)(6)) and any subsidiary of such a person other than a state regulated insurer.

\* \* \* \* \*

*State regulated insurer* means a person regulated by a state insurance regulator as defined in section 1002(22) of the Dodd-Frank Act (12 U.S.C. 5481(22)), and any subsidiary of such a person, other than a regulated foreign subsidiary and regulated foreign affiliate.

\* \* \* \* \*



## Subpart B—Capital Ratio Requirements and Buffers

■ 4. Section 217.10 is amended by adding paragraphs (a)(4), (6) and (7), to read as follows:

### § 217.10 Minimum capital requirements.

\* \* \* \*

(a) \* \* \*

(4) For a Board-regulated institution other than an insurance savings and loan holding company or insurance SLHC mid-tier holding company, a leverage ratio of 4 percent.

\* \* \* \*

(6) An insurance savings and loan holding company that is a state regulated insurer is not required to meet the minimum capital ratio requirements in paragraphs (a)(1) through (5) of this section, if the company uses subpart J of this part for purposes of compliance with the capital adequacy requirements and calculations in this part.

(7) An insurance savings and loan holding company is not required to meet the buffer in § 217.11, if the company uses subpart J of this part for purposes of compliance with the calculation of its capital conservation buffer.

\* \* \* \*

■ 5. Section 217.11 is amended by revising paragraph (a)(3) to read as follows:

### § 217.11 Capital conservation buffer, countercyclical capital buffer amount, and GSIB surcharge.

(a) \* \* \*

\* \* \* \*

(3) *Calculation of Capital Conservation Buffer.* (i) For a Board-regulated institution (other than an insurance savings and loan holding company that uses subpart J of this part for the purpose of calculating its capital conservation buffer) the capital conservation buffer is equal to the lowest of the following ratios, calculated as of the last day of the previous calendar quarter based on the Board-regulated institution's most recent Call Report, for a state member bank, or FR Y-9C, for a bank holding company or savings and loan holding company, as applicable:

\* \* \* \*

■ 6. In part 217, add subpart J, to read as follows:

## Subpart J—Capital Requirements for Board-regulated Institutions Significantly Engaged in Insurance Activities

Sec.

207.601 Purpose, applicability, reservations of authority, and scope

207.602 Definitions

207.603 Capital Requirements

207.604 Capital Conservation Buffer  
217.605 Determination of Building Blocks  
217.606 Scaling Parameters  
217.607 Capital Requirements under the Building Block Approach  
217.608 Available Capital Resources under the Building Block Approach

## Subpart J—Capital Requirements for Board-regulated Institutions Significantly Engaged in Insurance Activities

### § 217.601 Purpose, applicability, reservations of authority, and scope

(a) *Purpose.* This subpart establishes a framework for assessing overall risk-based capital for Board-regulated institutions that are significantly engaged in insurance activities. The framework in this subpart is used to measure available capital resources and capital requirements across a Board-regulated institution and its subsidiaries that are subject to diverse applicable capital frameworks, aggregate available capital resources and capital requirements, and calculate a ratio that reflects the overall capital adequacy of the Board-regulated institution. This subpart includes minimum BBA ratio and capital buffer requirements, public disclosure requirements, and transition provisions for the application of this subpart.

(b) *Applicability.* This section applies to every Board-regulated institution that is:

(1) (i) A top-tier depository institution holding company that is an insurance underwriting company; or

(ii) A top-tier depository institution holding company, that, as of June 30 of the previous calendar year, held 25 percent or more of its total consolidated assets in insurance underwriting companies (other than assets associated with insurance underwriting for credit risk). For purposes of this subparagraph (b)(ii), the Board-regulated institution must calculate its total consolidated assets in accordance with U.S. GAAP, or if the Board-regulated institution does not calculate its total consolidated assets under U.S. GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board; or

(2) An institution that is otherwise subject to this subpart, as determined by the Board.

(c) *Exclusion of certain SLHCs.* This subpart shall not apply to a top-tier depository institution holding company that

(i) Exclusively files financial statements in accordance with SAP;

(ii) Is not subject to a State insurance capital requirement; and

(iii) Has no subsidiary depository institution holding company that

(A) Is subject to a capital requirement; or

(B) Does not exclusively file financial statements in accordance with SAP.

(d) *Reservation of authority.*

(1) *Regulatory capital resources.*

(i) If the Board determines that a particular company capital element has characteristics or terms that diminish its ability to absorb losses, or otherwise present safety and soundness concerns, the Board may require the supervised insurance organization to exclude all or a portion of such element from building block available capital for a depository institution holding company in the supervised insurance organization.

(ii) Notwithstanding the provisions set forth in § 217.608, the Board may find that a capital resource may be included in the building block available capital of a depository institution holding company on a permanent or temporary basis consistent with the loss absorption capacity of the capital resource and in accordance with § 217.608(g).

(2) *Required capital amounts.* If the Board determines that the building block capital requirement for any depository institution holding company is not commensurate with the risks of the depository institution holding company, the Board may adjust the building block capital requirement and building block available capital for the supervised insurance organization.

(3) *Structural requirements.* In order to achieve the appropriate application of this subpart, the Board may require a supervised insurance organization to take any of the following actions with respect to the application of this subpart, if the Board determines that such action would better reflect the risk profile of an inventory company or the supervised insurance organization:

(i) Identify an inventory company that is a depository institution holding company as a top-tier depository institution holding company, or vice versa;

(ii) Identify any company as an inventory company, material financial entity, or building block parent;

(iii) Reverse the identification of a building block parent; or

(iv) Set a building block parent's allocation share of a downstream building block parent equal to 100 percent.

(e) *Other reservation of authority.* With respect to any treatment required under this subpart, the Board may require a different treatment, provided

that such alternative treatment is commensurate with the supervised insurance organization's risk and consistent with safety and soundness.

(f) *Notice and response procedures.* In making any determinations under this subpart, the Board will apply notice and response procedures in the same manner as the notice and response procedures in section 263.202 of this chapter.

#### § 217.602 Definitions

(a) Terms that are set forth in § 217.2 and used in this subpart have the definitions assigned thereto in § 217.2.

(b) For the purposes of this subpart, the following terms are defined as follows:

*Allocation share* means the portion of a downstream building block's available capital or building block capital requirement that a building block parent must aggregate in calculating its own building block available capital or building block capital requirement, as applicable.

*Applicable capital framework* is defined in § 217.605, provided that for purposes of § 217.605(b)(2), the NAIC RBC frameworks for life insurance, fraternal insurers, property and casualty insurance, and health insurance companies are different applicable capital frameworks.

*Assignment* means the process of associating an inventory company with one or more building block parents for purposes of inclusion in the building block parents' building blocks.

*BBA ratio* is defined in § 217.603.

*Building block* means a building block parent and all downstream companies and subsidiaries assigned to the building block parent.

*Building block available capital* has the meaning set out in § 217.608.

*Building block capital requirement* has the meaning set out in § 217.607.

*Building block parent* means the lead company of a building block whose applicable capital framework must be applied to all members of a building block for purposes of determining building block available capital and the building block capital requirement.

*Capital-regulated company* means a company in a supervised insurance organization that is directly subject to a regulatory capital framework.

*Common capital framework* means NAIC RBC.

*Company available capital* means, for a company, the amount of its company capital elements, net of any adjustments and deductions, as determined in accordance with the company's applicable capital framework.

*Company capital element* means, for purposes of this subpart, any part, item,

component, balance sheet account, instrument, or other element qualifying as regulatory capital under a company's applicable capital framework prior to any adjustments and deductions under that framework.

*Company capital requirement* means:

(1) For a company whose applicable capital framework is NAIC RBC, the Authorized Control Level risk-based capital requirement;

(2) For a company whose applicable capital framework is a U.S. federal banking capital rule, the total risk-weighted assets; and

(3) For any other company, a risk-sensitive measure of required capital used to determine the jurisdictional intervention point applicable to that company.

*Downstream building block parent* means a building block parent that is a downstream company of another building block parent.

*Downstream company* means a company whose company capital element is directly or indirectly owned, in whole or in part by, another company in the supervised insurance organization.

*Downstreamed capital* means direct ownership of a downstream company's company capital element that is accretive to a downstream building block parent's building block available capital.

*Engaged in insurance or reinsurance underwriting* means, for a company, to be regulated as an insurance or reinsurance underwriting company, other than insurance underwriting companies that primarily underwrite title insurance or insurance for credit risk.

*Financial entity* means:

(1) A bank holding company; a savings and loan holding company as defined in section 10(n) of the Home Owners' Loan Act (12 U.S.C. 1467a(n)); a U.S. intermediate holding company established or designated for purposes of compliance with this part;

(2) A depository institution as defined in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)); an organization that is organized under the laws of a foreign country and that engages directly in the business of banking outside the United States; a federal credit union or state credit union as defined in section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) and (6)); a national association, state member bank, or state nonmember bank that is not a depository institution; an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act of 1956 (12 U.S.C.

1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)(2)(H));

(3) An entity that is state-licensed or registered as:

(i) A credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;

(ii) A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

(4) Any person registered with the Commodity Futures Trading Commission as a swap dealer or major swap participant pursuant to the Commodity Exchange Act of 1936 (7 U.S.C. 1 *et seq.*), or an entity that is registered with the U.S. Securities and Exchange Commission as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);

(5) A securities holding company as defined in section 618 of the Dodd-Frank Act (12 U.S.C. 1850a); a broker or dealer as defined in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)–(5)); an investment company registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*); or a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–53(a));

(6) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a–7 (17 CFR 270.3a–7) of the U.S. Securities and Exchange Commission;

(7) A commodity pool, a commodity pool operator, or a commodity trading

advisor as defined, respectively, in sections 1a(10), 1a(11), and 1a(12) of the Commodity Exchange Act (7 U.S.C. 1a(10), 1a(11), and 1a(12)); a floor broker, a floor trader, or introducing broker as defined, respectively, in sections 1a(22), 1a(23) and 1a(31) of the Commodity Exchange Act (7 U.S.C. 1a(22), 1a(23), and 1a(31)); or a futures commission merchant as defined in section 1a(28) of the Commodity Exchange Act (7 U.S.C. 1a(28));

(8) An entity that is organized as an insurance company, primarily engaged in underwriting insurance or reinsuring risks underwritten by insurance companies;

(9) Any designated financial market utility, as defined in section 803 of the Dodd-Frank Act (12 U.S.C. 5462); and

(10) An entity that would be a financial entity described in paragraphs (1) through (9) of this definition, if it were organized under the laws of the United States or any State thereof.

*Inventory* has the meaning set out in paragraph (a) of § 217.602(b)(2).

*Material* means, for a company in the supervised insurance organization:

(1) Where the top-tier depository institution holding company's total exposure exceeds 1 percent of total consolidated assets of the top-tier depository institution holding company. The supervised firm must calculate its total consolidated assets in accordance with U.S. GAAP, or if the firm does not calculate its total consolidated assets under U.S. GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board. For purposes of this definition, total exposure includes:

(a) The absolute value of the top-tier depository institution holding company's direct or indirect interest in the company capital elements of the company;

(b) The top-tier depository institution holding company or any other company in the supervised insurance organization providing an explicit or implicit guarantee for the benefit of the company; and

(c) Potential counterparty credit risk to the top-tier depository institution holding company or any other company in the supervised insurance organization arising from any derivative or similar instrument, reinsurance or similar arrangement, or other contractual agreement; or

(2) The company is otherwise significant in assessing the building block available capital or building block capital requirement of the top-tier depository institution holding company

based on factors including risk exposure, activities, organizational structure, complexity, affiliate guarantees or recourse rights, and size.

*Material financial entity* means a financial entity that, together with its subsidiaries, but excluding any subsidiary capital-regulated company (or subsidiary thereof), is material, provided that an inventory company is not eligible to be a material financial entity if:

(1) The supervised insurance organization has elected pursuant to § 217.605(c) to not treat the company as a material financial entity.

(2) The inventory company is a financial subsidiary, as defined in section 121 of the Gramm-Leach-Bliley Act;

(3) The inventory company is properly registered as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*), or with any state.

*Member* means, with respect to a building block, the building block parent or any of its downstream companies or subsidiaries that have been assigned to a building block.

*NAIC* means the National Association of Insurance Commissioners.

*NAIC RBC* means the most recent version of the Risk-Based Capital (RBC) For Insurers Model Act, together with the RBC instructions, as adopted in a substantially similar manner by an NAIC member and published in the NAIC's Model Regulation Service.

*Permitted Accounting Practice* means an accounting practice specifically requested by a state regulated insurer that departs from SAP and state prescribed accounting practices, and has received approval from the state regulated insurer's domiciliary state regulatory authority.

*Prescribed Accounting Practice* means an accounting practice that is incorporated directly or by reference to state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

*Recalculated building block capital requirement* means, for a downstream building block parent and an upstream building block parent, the downstream building block parent's building block capital requirement recalculated assuming that the downstream building block parent had no upstream investment in the upstream building block parent.

*Regulatory capital framework* means, with respect to a company, the applicable legal requirements, excluding this subpart, specifying the minimum amount of total regulatory capital the

company must hold to avoid restrictions on distributions and discretionary bonus payments, regulatory intervention on the basis of capital adequacy levels for the company, or equivalent standards; provided that for purposes of this subpart, the NAIC RBC frameworks for life insurance, fraternal insurance, property and casualty insurance, and health insurance companies are different regulatory capital frameworks.

*SAP* means Statutory Accounting Principles as promulgated by the NAIC and adopted by a jurisdiction for purposes of financial reporting by insurance companies.

*Scaling* means the translation of building block available capital and building block capital requirement from one applicable capital framework to another by application of § 217.606.

*Scalar-compatible* means a capital framework:

(1) For which the Board has determined scalars; or

(2) That is an insurance capital regulatory framework, and exhibits each of the following three attributes:

(a) the framework is clearly defined and broadly applicable;

(b) The framework has an identifiable intervention point that can be used to calibrate a scalar; and

(c) The framework provides a risk-sensitive measure of required capital reflecting material risks to a company's financial strength.

*Submission date* means the date as of which Form FR Q-1 is filed with the Board.

*Supervised insurance organization* means:

(1) In the case of a depository institution holding company, the set of companies consisting of:

(i) A top-tier depository institution holding company that is an insurance underwriting company, together with its inventory companies; or

(ii) A top-tier depository institution holding company, together with its inventory companies, that, as of June 30 of the previous calendar year, held 25 percent or more of its total consolidated assets in insurance underwriting companies (other than assets associated with insurance underwriting for credit risk). For purposes of this paragraph (1)(ii) of this definition, the supervised firm must calculate its total consolidated assets in accordance with U.S. GAAP, or if the firm does not calculate its total consolidated assets under U.S. GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board; or

(2) An institution that is otherwise subject to this subpart, as determined by the Board.

*Tier 2 capital instruments*, for purposes of this subpart, has the meaning set out in § 217.608(a).

*Top-tier depository institution holding company* means a savings and loan holding company that is not controlled by another savings and loan holding company.

*Upstream building block parent* means an upstream company that is a building block parent.

*Upstream company* means a company within a supervised insurance organization that directly or indirectly controls a downstream company, or directly or indirectly owns part or all of a downstream company's company capital elements.

*Upstream investment* means any direct or indirect investment by a downstream building block parent in an upstream building block parent.

*U.S. federal banking capital rules* mean this part, other than this subpart,

and the regulatory capital rules promulgated by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

#### § 217.603 Capital Requirements

(a) *Generally*. A supervised insurance organization must determine its BBA ratio, subject to the minimum requirement set out in this section and buffer set out in § 217.604, for each depository institution holding company within its enterprise by:

(1) Establishing an inventory that includes the supervised insurance organization and every company that meets the requirements of § 217.605(b)(1);

(2) Identifying all building block parents as required under § 217.605(b)(3);

(3) Determining the available capital and capital requirement for each building block parent in accordance with its applicable capital framework;

(4) Determining the building block available capital and building block

capital requirement for each building block, reflecting adjustments and scaling as set out in this subpart;

(5) Rolling up building block available capital and building block capital requirement amounts across all building blocks in the supervised insurance organization's enterprise to determine the same for any depository institution holding companies in the enterprise; and

(6) Determining the ratio of building block available capital to building block capital requirement for each depository institution holding company in the supervised insurance organization.

(b) *Determination of BBA ratio*. For a depository institution holding company in a supervised insurance organization, the BBA ratio is the ratio of the company's building block available capital to the company's building block capital requirement, each scaled to the common capital framework in accordance with § 217.606. Expressed formulaically:

$$BBA \text{ Ratio} = \frac{\text{Building block available capital}}{\text{Building block capital requirement}}$$

(c) *Minimum capital requirement*. A depository institution holding company in a supervised insurance organization must maintain a BBA ratio of at least 250 percent.

(d) *Capital adequacy*. (1) Notwithstanding the minimum requirement in this subpart, a depository institution holding company in a supervised insurance organization must maintain capital commensurate with the level and nature of all risks to which the supervised insurance organization is exposed. The supervisory evaluation of the depository institution holding company's capital adequacy is based on an individual assessment of numerous factors, including the character and condition of the company's assets and its existing and prospective liabilities and other corporate responsibilities.

(2) A depository institution holding company in a supervised insurance organization must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital.

#### § 217.604 Capital Conservation Buffer

(a) *Application of § 217.11(a)*. A top-tier depository institution holding company in a supervised insurance organization must comply with

§ 217.11(a) as modified solely for application in this subpart by:

(1) Replacing the term "calendar quarter" with "calendar year;"

(2) Including in the definition of "distribution" discretionary dividend payments on participating insurance policies;

(3) In § 217.11(a)(1), replacing "common equity tier 1 capital" with "building block available capital excluding tier 2 instruments;"

(4) Replacing § 217.11(a)(2)(i) in its entirety with the following: "Eligible retained income. The eligible retained income of a depository institution holding company in a supervised insurance organization is the annual change in the company's building block available capital, calculated as of the last day of the current and immediately preceding calendar years based on the supervised insurance organization's most recent Form FR Q-1, net of any distributions and accretion to building block available capital from capital instruments issued in the current or immediately preceding calendar year, excluding issuances corresponding with retirement of capital instruments under paragraph (1) of this section of the definition of distribution;

(5) Replacing § 217.11(a)(3) in its entirety with the following: "The capital conservation buffer for a depository institution holding company in a

supervised insurance organization is the greater of its BBA ratio, calculated as of the last day of the previous calendar year based on the supervised insurance organization's most recent Form FR Q-1, minus the minimum capital requirement under § 217.603(c), and zero;"

(6) Replacing § 217.11(a)(4)(ii) in its entirety with the following: "A depository institution holding company in a supervised insurance organization with a capital conservation buffer that is greater than 235 percent is not subject to a maximum payout amount under this section;

(7) In § 217.11(a)(4)(iii)(B), replacing "2.5 percent" with "235 percent;"

(8) Replacing Table 1 to § 217.11 in its entirety with the following:

TABLE 1 TO § 217.604—CALCULATION OF MAXIMUM PAYOUT AMOUNT

Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
Greater than 235 percent.	No payout ratio limitation applies.
Less than or equal to 235 percent, and greater than 177 percent.	60 percent.

TABLE 1 TO § 217.604—CALCULATION OF MAXIMUM PAYOUT AMOUNT—Continued

Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
Less than or equal to 177 percent, and greater than 118 percent.	40 percent.
Less than or equal to 118 percent, and greater than 59 percent.	20 percent.
Less than or equal to 59 percent.	0 percent.

**§ 217.605 Determination of Building Blocks**

(a) *General.* A supervised insurance organization must identify each building block parent and its allocation share of any downstream building block parent, as applicable.

(b) *Operation.* To identify building block parents and determine allocation shares, a supervised insurance organization must take the following steps in the following order:

(1) *Inventory of companies.* A supervised insurance organization must identify as inventory companies: (i) All companies that are

(A) Required to be reported on the FR Y-6;

(B) Required to be reported on the FR Y-10; or

(C) Classified as affiliates in accordance with NAIC Statement of Statutory Accounting Principles (SSAP) No. 25 and the preparation of Schedule Y;

(ii) Any company, special purpose entity, variable interest entity, or similar entity that:

(A) Enters into one or more reinsurance or derivative transactions with inventory companies identified pursuant to paragraph (b)(1)(i) of this section;

(B) Is material;

(C) Is engaged in activities such that one or more inventory companies identified pursuant to paragraph (b)(1)(i) of this section are expected to absorb more than 50 percent of its expected losses; and

(D) Is not otherwise identified as an inventory company; and

(iii) Any other company that the Board determines must be identified as an inventory company.

(2) *Determination of applicable capital framework.* (i) A supervised insurance organization must:

(A) Determine the applicable capital framework for each inventory company; and

(B) Identify inventory companies that are subject to a regulatory capital framework.

(ii) The applicable capital framework for an inventory company is:

(A) If the inventory company is not engaged in insurance or reinsurance underwriting, the U.S. federal banking capital rules, in particular:

(1) If the inventory company is not a depository institution, subparts A through F of this part; and

(2) If the inventory company is a depository institution, the regulatory capital framework applied to the depository institution by the appropriate primary federal regulator, *i.e.*, subparts A through F of this part (Board), parts 3 of this title (Office of the Comptroller of the Currency), or part 324 of this title (Federal Deposit Insurance Corporation), as applicable;

(B) If the inventory company is engaged in insurance or reinsurance underwriting and subject to a regulatory capital framework that is scalar-compatible, the regulatory capital framework; and

(C) If the inventory company is engaged in insurance or reinsurance underwriting and not subject to a regulatory capital framework that is scalar-compatible, then NAIC RBC for life insurers, fraternal insurers, health insurers, or property & casualty insurers based on the company's primary source of premium revenue.

(3) *Identification of building block parents.* A supervised insurance organization must identify all building block parents according to the following procedure:

(i) (A) Identify all top-tier depository institution holding companies in the supervised insurance organization.

(B) Any top-tier depository institution holding company is a building block parent

(ii) (A) Identify any inventory company that is a depository institution holding company;

(B) An inventory company identified in paragraph (b)(3)(ii)(A) of this section is a building block parent.

(iii) Identify all inventory companies that are capital-regulated companies (*i.e.*, inventory companies that are subject to a regulatory capital framework) or material financial entities.

(iv) (A) Of the inventory companies identified in paragraph (b)(3)(iii) of this section, identify any inventory company that:

(1) Is assigned an applicable capital framework that is different from the

applicable capital framework of any next upstream inventory company identified in paragraphs (b)(3)(i) through (iii) of this section;<sup>1</sup> and

(2) Is assigned an applicable capital framework for which the Board has determined a scalar or, if the company in aggregate with all other companies subject to the same applicable capital framework are material, a provisional scalar;

(B) Of the inventory companies identified in paragraph (b)(3)(iii) of this section, identify any inventory company that:

(1) Is assigned an applicable capital framework that is the same as the applicable capital framework of each next upstream inventory company identified in paragraphs (b)(3)(i) through (iii) of this section;

(2) Is assigned an applicable capital framework for which the Board has determined a scalar or, if the company in aggregate with all other companies subject to the same applicable capital framework are material, a provisional scalar; and

(3) Is owned, in whole or part, by an inventory company that is subject to the same regulatory capital framework and the owner:

(i) Applies a charge on the inventory company's equity value in calculating its company capital requirement; or

(ii) Deducts all or a portion of its investment in the inventory company in calculating its company available capital.

(C) An inventory company identified in paragraph (b)(3)(iv)(A) through (B) of this section is a building block parent.

(v) Include any inventory company identified in paragraph (b)(1)(ii) of this section as a building block parent.

(vi) (A) Identify any inventory company

(1) For which more than one building block parent, as identified pursuant to paragraphs (b)(3)(i) through (v) of this section, owns a company capital element either directly or indirectly other than through another such building block parent; and

(2) (i) Is consolidated under any such building block parent's applicable capital framework; or

<sup>1</sup> In a simple structure, an inventory company would compare its applicable capital framework to the applicable capital framework of its parent company. However, if the parent company does not meet the criteria to be identified as a building block parent, the inventory company must compare its capital framework to the next upstream company that is eligible to be identified as a building block parent. For purposes of this paragraph (b)(3)(iv) of this section, a company is "next upstream" to a downstream company if it owns, in whole or in part, the downstream company either directly, or indirectly other than through a company identified in paragraphs (b)(3)(ii) through (iii) of this section.

(ii) Owns downstreamed capital.  
(B) An inventory company identified in paragraph (b)(3)(vi)(A) of this section is a building block parent.

(4) *Building blocks.* (A) Except as provided in paragraph (b)(4)(B) of this section, a supervised insurance organization must assign an inventory company to the building block of any building block parent that owns a company capital element of the inventory company, or of which the inventory company is a subsidiary,<sup>2</sup> directly or indirectly through any company other than a building block parent, unless the inventory company is a building block parent.

(B) A supervised insurance organization is not required to assign to a building block any inventory company that is not a downstream company or subsidiary of a top-tier depository institution holding company.

(5) *Financial Statements.* The supervised insurance organization must:

(i) For any inventory company whose applicable capital framework is NAIC RBC, prepare financial statements in accordance with SAP; and

(ii) For any building block parent whose applicable capital framework is subparts A through F of this part:

(A) Apply the same elections and treatment of exposures as are applied to the subsidiary depository institution;

(B) Apply subparts A through F of this part, to the members of the building block of which the building block parent is a member, on a consolidated basis, to the same extent as if the building block parent were a Board-regulated institution; and

(C) Where the building block parent is not the top-tier depository institution holding company, not deduct investments in capital of unconsolidated financial institutions, nor exclude these investments from the calculation of risk-weighted assets.

(6) *Allocation share.* A supervised insurance organization must, for each building block parent, identify any downstream building block parent owned directly or indirectly through any company other than a building block parent, and determine the building block parent's allocation share of these downstream building block parents pursuant to paragraph (d) of this section.

(c) *Material financial entity election.*

(1) A supervised insurance organization may elect to not treat an inventory company meeting the criteria in

paragraph (c)(2) of this section as a material financial entity. An election under this section must be included with the first financial statements submitted to the Board after the company is included in the supervised insurance organization's inventory.

(2) The election in paragraph (c)(1) of this section is available as to an inventory company if:

(i) That company engages in transactions consisting solely of either (A) transactions for the purpose of transferring risk from one or more affiliates within the supervised insurance organization to one or more third parties; or (B) transactions to invest assets contributed to the company by one or more affiliates within the supervised insurance organization, where the company is established for purposes of limiting tax obligation or legal liability; and

(ii) The supervised insurance organization is able to calculate the adjustment required in § 217.607(b)(4).

(d) *Allocation share.* (1) Except as provided in paragraph (d)(2) of this section, a building block parent's allocation share of a downstream building block parent is calculated as Allocation Share<sub>UpBBP</sub> =

$$\frac{(\text{Tier2}_{\text{UpBBP}} + (\text{DownAC} - \text{UpInvestment} - \text{Tier2}_{\text{Total}}) * \text{ProRataAllocation}_{\text{UpBBP}})}{(\text{DownAC} - \text{UpInvestment})}$$

(i) UpBBP = The building block parent that owns a company capital element of DownBBP directly or indirectly through a member of UpBBP's building block.

(ii) DownBBP = The building block parent whose company capital element is owned by UpBBP directly or indirectly through a member of UpBBP's building block.

(iii) Tier2 = The value of tier 2 instruments issued by DownBBP, where Tier2<sub>UpBBP</sub> is the amount that is owned by any member of UpBBP's building block and Tier2<sub>Total</sub> is the total amount issued by DownBBP.<sup>3</sup>

(iv) UpInvestment = Any upstream investment by DownBBP in UpBBP.<sup>4</sup>

(v) ProRataAllocation<sub>UpBBP</sub> = UpBBP's share of DownBBP based on equity ownership of DownBBP, including associated paid-in capital.

(vi) DownAC = Total building block available capital of DownBBP.

(2) The top-tier depository institution's allocation share of a building block parent identified under paragraph (b)(3)(v) of this section is 100 percent. Any other building block parent's allocation share of such building block parent is zero.

#### § 217.606 Scaling Parameters

(a) *Scaling specified by the Board.*

(1) *Scaling between the U.S. federal banking capital rules and NAIC RBC.*

(i) *Scaling capital requirement.* When calculating (in accordance with § 217.607) the building block capital requirement for a building block parent, the applicable capital framework which is NAIC RBC or the U.S. federal banking capital rules, and where the applicable capital framework of the appropriate downstream building block parent is NAIC RBC or the U.S. federal banking capital rules, the capital requirement scaling modifier is provided by Table 1 to § 217.606.

TABLE 1 TO § 217.606—CAPITAL REQUIREMENT SCALING MODIFIERS FOR NAIC RBC AND THE U.S. FEDERAL BANKING CAPITAL RULES

Downstream building block parent's applicable capital framework:	Upstream building block parent's applicable capital framework:	
	NAIC RBC	U.S. federal banking capital rules
U.S. federal banking capital rules .....	1.06 percent ( <i>i.e.</i> , 0.0106) .....	1.

<sup>2</sup> For purposes of this section, subsidiary includes a company that is required to be reported on the FR Y-6, FR Y-10, or NAIC's Schedule Y, as applicable.

<sup>3</sup> The amounts of Tier2 should be valued consistently with how the instruments are reported in DownBBP's financial statements.

<sup>4</sup> The amount of the upstream investment is calculated as the impact, excluding any impact on taxes, on DownBBP's company available capital if DownBBP were to deduct the investment.

TABLE 1 TO § 217.606—CAPITAL REQUIREMENT SCALING MODIFIERS FOR NAIC RBC AND THE U.S. FEDERAL BANKING CAPITAL RULES—Continued

Downstream building block parent's applicable capital framework:	Upstream building block parent's applicable capital framework:	
	NAIC RBC	U.S. federal banking capital rules
NAIC RBC .....	1 .....	94.3.

(ii) *Scaling available capital.* When calculating (in accordance with § 217.608) the building block available capital for a building block parent, the applicable capital framework which is

NAIC RBC or the U.S. federal banking capital rules, and where the applicable capital framework of the appropriate downstream building block parent is NAIC RBC or the U.S. federal banking

capital rules, the available capital scaling modifier is provided by Table 2 to § 217.606.

TABLE 2 TO § 217.606—AVAILABLE CAPITAL SCALING MODIFIERS FOR NAIC RBC AND THE U.S. FEDERAL BANKING CAPITAL RULES

Downstream building block parent's applicable capital framework:	Upstream building block parent's applicable capital framework:	
	NAIC RBC	U.S. federal banking capital rules
U.S. federal banking capital rules .....	Recalculated building block capital requirement * -6.3 percent (i.e., -0.063).	0.
NAIC RBC .....	0 .....	Recalculated building block capital requirement * 5.9.

(2) [Reserved]

(b) *Scaling not specified by the Board but framework is scalar-compatible.* Where scaling modifier to be used in § 217.607 or § 217.608 is not specified in paragraph (a) of this section, and the building block parent's applicable capital framework is scalar-compatible, the scaling modifier is determined as follows:

(1) *Definitions.* For purposes of this section, the following definitions apply:

(i) *Jurisdictional intervention point.* The jurisdictional intervention point is the capital level, under the laws of the jurisdiction, at which the supervisory authority in the jurisdiction may intervene as to a company subject to the applicable capital framework by imposing restrictions on distributions and discretionary bonus payments by the company or, if no such intervention may occur in a jurisdiction, then the capital level at which the supervisory

authority would first have the authority to take action against a company based on its capital level; and

(ii) *Jurisdiction adjustment.* The jurisdictional adjustment is the risk adjustment set forth in Table 3 to § 217.606, based on the country risk classification set by the Organization for Economic Cooperation and Development for the jurisdiction.

TABLE 3 TO § 217.606—JURISDICTIONAL ADJUSTMENTS BY OECD COUNTRY RISK CLASSIFICATION

OECD CRC	Jurisdictional Adjustment (percent)
0–1, including jurisdictions with no OECD country risk classification .....	0
2 .....	20

TABLE 3 TO § 217.606—JURISDICTIONAL ADJUSTMENTS BY OECD COUNTRY RISK CLASSIFICATION—Continued

OECD CRC	Jurisdictional Adjustment (percent)
3 .....	50
4–6 .....	100
7 .....	150

(2) *Scaling capital requirement.* When calculating (in accordance with § 217.607) the building block capital requirement for a building block parent, where the applicable capital framework of the appropriate downstream building block parent is a scalar-compatible framework for which the Board has not specified a capital requirement scaling modifier, the capital requirement scaling modifier is equal to:

$$\frac{(1 + \text{Adjustment}_{\text{Scaling from}}) * \text{Requirement}_{\text{Scaling from}}}{\text{Requirement}_{\text{Scaling to}}}$$

Where:

$\text{Adjustment}_{\text{Scaling from}}$  is equal to the jurisdictional adjustment of the downstream building block parent;

$\text{Requirement}_{\text{Scaling from}}$  is equal to the jurisdictional intervention point of the downstream building block parent; and

$\text{Requirement}_{\text{Scaling to}}$  is equal to the jurisdictional intervention point of the upstream building block parent.

(3) *Scaling available capital.* When calculating (in accordance with § 217.608) the building block available capital for a building block parent, where the applicable capital framework of the appropriate downstream building block parent is a scalar-compatible framework for which the Board has not specified an available capital scaling

modifier, the available capital scaling modifier is equal to zero.

#### § 217.607 Capital Requirements under the Building Block Approach

(a) *Determination of building block capital requirement.* For each building block parent, *building block capital requirement* means the sum of the items



in paragraphs (a)(1) through (2) of this section:

(1) The company capital requirement of the building block parent;

(i) Recalculated under the assumption that members of the building block parent's building block had no investment in any downstream building block parent; and

(ii) Adjusted pursuant to paragraph (b) of this section;

(2) For each downstream building block parent, the adjusted downstream building block capital requirement ( $BBCR_{ADJ}$ ), which equals:

$$BBCR_{ADJ} = BBCR_{DS} \cdot CRSM \cdot AS$$

Where:

(i)  $BBCR_{DS}$  = The building block capital requirement of the downstream building block parent recalculated under the assumption that the downstream building block parent had no upstream investment in the building block parent;

(ii)  $CRSM$  = The appropriate capital requirement scaling modifier under § 217.606; and

(iii)  $AS$  = The building block parent's allocation share of the downstream building block parent.

(b) *Adjustments in determining the building block capital requirement.* A supervised insurance organization subject to this subpart must adjust the company capital requirement for any building block parent as follows:

(1) *Internal credit risk charges.* A supervised insurance organization must deduct from the building block parent's company capital requirement any difference between:

(i) The building block parent's company capital requirement; and

(ii) The building block parent's company capital requirement recalculated excluding capital requirements related to potential for the possibility of default of any company in the supervised insurance organization.

(2) *Permitted accounting practices and prescribed accounting practices.* A supervised insurance organization must deduct from the building block parent's company capital requirement any difference between:

(i) The building block parent's company capital requirement, after making any adjustment in accordance with paragraph (b)(1) of this section; and

(ii) The building block parent's company capital requirement, after making any adjustment in accordance with paragraph (b)(1) of this section, recalculated under the assumption that neither the building block parent, nor any company that is a member of that building block parent's building block, had prepared its financial statements with the application of any permitted

accounting practice, prescribed accounting practice, or other practice, including legal, regulatory, or accounting procedures or standards, that departs from a solvency framework as promulgated for application in a jurisdiction.

(3) *Transitional measures in applicable capital frameworks.* A supervised institution must deduct from the building block parent's company capital requirement any difference between:

(i) The building block parent's company capital requirement; and

(ii) The building block parent's company capital requirement recalculated under the assumption that neither the building block parent, nor any company that is a member of the building block parent's building block, had prepared its financial statements with the application of any grandfathering or transitional measures under the building block parent's applicable capital framework, unless the application of these measures has been approved by the Board.

(4) *Risks of certain intermediary entities.* Where a supervised insurance organization has made an election with respect to a company not to treat that company as a material financial entity pursuant to § 217.605(c), the supervised insurance organization must add to the company capital requirement of any building block parent, whose building block contains a member, with which the company engages in one or more transactions, and for which the company engages in one or more transactions described in § 217.605(c)(2) with a third party, any difference between:

(i) The building block parent's company capital requirement; and

(ii) The building block parent's company capital requirement recalculated with the risks of the company, excluding internal credit risks described in paragraph (b)(1) of this section, allocated to the building block parent, reflecting the transaction(s) that the company engages in with any member of the building block parent's building block.<sup>1</sup>

(5) *Investments in own capital instruments.*

(i) A supervised insurance organization must deduct from the building block parent's company capital requirement any difference between:

(A) The building block parent's company capital requirement; and

<sup>1</sup> The total allocation of the risks of the intermediary entity to building block parents must capture all material risks and avoid double counting.

(B) The building block parent's company capital requirement recalculated after assuming that neither the building block parent, nor any company that is a member of the building block parent's building block, held any investment in the building block parent's own capital instrument(s), including any net long position determined in accordance with paragraph (b)(5)(ii) of this section.

(ii) *Net long position.* For purposes of calculating an investment in a building block parent's own capital instrument under this section, the net long position is determined in accordance with § 217.22(h), provided that a separate account asset or associated guarantee is not regarded as an indirect exposure unless the net long position of the fund underlying the separate account asset (determined in accordance with § 217.22(h) without regard to this paragraph) equals or exceeds 5 percent of the value of the fund.

(6) *Risks relating to title insurance.* A supervised insurance organization must add to the building block parent's company capital requirement the amount of the building block parent's reserves for claims pertaining to title insurance, multiplied by 300 percent.

#### **§ 217.608 Available Capital Resources under the Building Block Approach**

(a) *Qualifying capital instruments.*

(1) Under this subpart, a qualifying capital instrument with respect to a building block parent is a capital instrument that meets the following criteria:

(i) The instrument is issued and paid-in;

(ii) The instrument is subordinated to depositors and general creditors of the building block parent;

(iii) The instrument is not secured, not covered by a guarantee of the building block parent or of an affiliate of the building block parent, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;

(iv) The instrument has a minimum original maturity of at least five years. At the beginning of each of the last five years of the life of the instrument, the amount that is eligible to be included in building block available capital is reduced by 20 percent of the original amount of the instrument (net of redemptions), and is excluded from building block available capital when the remaining maturity is less than one year. In addition, the instrument must not have any terms or features that require, or create significant incentives

for, the building block parent to redeem the instrument prior to maturity.<sup>1</sup>

(v) The instrument, by its terms, may be called by the building block parent only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in the building block parent's company available capital or building block available capital, a tax event, or if the issuing entity is required to register as an investment company pursuant to the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*). In addition:

(A) The top-tier depository institution holding company must receive the prior approval of the Board to exercise a call option on the instrument.

(B) The building block parent does not create at issuance, through action or communication, an expectation the call option will be exercised.

(C) Prior to exercising the call option, or immediately thereafter, the Board-regulated institution must either: Replace any amount called with an equivalent amount of an instrument that meets the criteria for regulatory capital under this section;<sup>2</sup> or demonstrate to the satisfaction of the Board that following redemption, the Board-regulated institution would continue to hold an amount of capital that is commensurate with its risk.

(vi) Redemption of the instrument prior to maturity or repurchase requires the prior approval of the Board.

(vii) The instrument meets the criteria in § 217.20(d)(1)(vi) through (ix) and § 217.20(d)(1)(xi), *except that* each instance of "Board-regulated institution" is replaced with "building block parent" and, in § 217.20(d)(1)(ix), "tier 2 capital instruments" is replaced with "qualifying capital instruments".

(2) *Differentiation of tier 2 capital instruments.* For purposes of this subpart, tier 2 capital instruments of a top-tier depository institution holding company are instruments issued by any inventory company that are qualifying capital instruments under paragraph (a)(1) of this section,<sup>3</sup> other than those

qualifying capital instruments that meet all of the following criteria:

(i) The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other qualifying capital instruments (other than tier 2 capital instruments) before any losses are borne by holders of claims on the top-tier depository institution holding company with greater priority in a receivership, insolvency, liquidation, or similar proceeding.

(ii) The paid-in amount would be classified as equity under GAAP.

(iii) The instrument meets the criteria in § 217.20(b)(1)(i) through (vii) and in § 217.20(b)(1)(x) through (xiii).

(b) *Determination of building block available capital.* (1) For each building block parent, *building block available capital* means the sum of the items described in paragraphs (b)(1)(i) and (b)(1)(ii) of this section:

(i) The company available capital of the building block parent:

(A) Less the amount of downstreamed capital owned by any member of the building block parent's building block;<sup>4</sup> and

(B) Adjusted pursuant to paragraph (c) of this section;

(ii) For each downstream building block parent, the adjusted downstream building block available capital ( $BBAC_{ADJ}$ ), which equals:

$$BBAC_{ADJ} = (BBAC_{DS} - UpInv + ACSM) \cdot AS$$

Where:

(A)  $BBAC_{DS}$  = The building block available capital of the downstream building block parent;

(B)  $UpInv$  = the amount of any upstream investment held by that downstream building block parent in the building block parent;<sup>5</sup>

(C)  $ACSM$  = The appropriate available capital scaling modifier under § 217.606; and

(D)  $AS$  = The building block parent's allocation share of the downstream building block parent.

(2) *Single tier of capital.* If there is more than one tier of company available capital under a building block parent's applicable capital framework, the amounts of company available capital from all tiers are combined in calculating building block available

capital in accordance with paragraph (b) of this section.

(c) *Adjustments in determining building block available capital.* For purposes of the calculations required in paragraph (b) of this section, a supervised insurance organization must adjust the company available capital for any building block parent as follows:

(1) *Non-qualifying capital instruments.* A supervised insurance organization must deduct from the building block parent's company available capital any accretion arising from any instrument issued by any company that is a member of the building block parent's building block, where the instrument is not a qualifying capital instrument.

(2) *Insurance underwriting RBC.*

When applying the U.S. federal banking capital rules as the applicable capital framework for a building block parent, a supervised insurance organization must add back into the building block parent's company available capital any amounts deducted pursuant to section .22(b)(3) of those rules.

(3) *Permitted accounting practices and prescribed accounting practices.* A supervised insurance organization must deduct from the building block parent's company available capital any difference between:

(i) The building block parent's company available capital; and

(ii) The building block parent's company available capital recalculated under the assumption that neither the building block parent, nor any company that is a member of that building block parent's building block, had prepared its financial statements with the application of any permitted accounting practice, prescribed accounting practice, or other practice, including legal, regulatory, or accounting procedures or standards, that departs from a solvency framework as promulgated for application in a jurisdiction.

(4) *Transitional measures in applicable capital frameworks.* A supervised institution must deduct from the building block parent's company available capital any difference between:

(i) The building block parent's company available capital; and

(ii) The building block parent's company available capital recalculated under the assumption that neither the building block parent, nor any company that is a member of the building block parent's building block, had prepared its financial statements with the application of any grandfathering or transitional measures under the building block parent's applicable capital framework, unless the

<sup>1</sup> An instrument that by its terms automatically converts into a qualifying capital instrument prior to five years after issuance complies with the five-year maturity requirement of this criterion.

<sup>2</sup> A building block parent may replace qualifying capital instruments concurrent with the redemption of existing qualifying capital instruments.

<sup>3</sup> For purposes of this paragraph (a)(2) of this section, the supervised insurance organization evaluates the criteria in paragraph (a)(1) of this section with regard to the building block in which the issuing inventory company is a member.

<sup>4</sup> The amount of the downstreamed capital is calculated as the impact, excluding any impact on taxes, on the company available capital of the building block parent of the building block of which the owner is a member, if the owner were to deduct the downstreamed capital.

<sup>5</sup> The amount of the upstream investment is calculated as the impact, excluding any impact on taxes, on the downstream building block parent's building block available capital if the owner were to deduct the investment.

application of these measures has been approved by the Board.

(5) *Deduction of investments in own capital instruments.*

(i) A supervised insurance organization must deduct from the building block parent's company available capital any investment by the building block parent in its own capital instrument(s), or any investment by any member of the building block parent's building block in capital instruments of the building block parent, including any net long position determined in accordance with paragraph (c)(5)(ii) of this section, to the extent that such investment(s) would otherwise be accretive to the building block parent's building block available capital.

(ii) *Net long position.* For purposes of calculating an investment in a building block parent's own capital instrument under this section, the net long position is determined in accordance with § 217.22(h), provided that a separate account asset or associated guarantee is not regarded as an indirect exposure unless the net long position of the fund underlying the separate account asset (determined in accordance with § 217.22(h) without regard to this paragraph) equals or exceeds 5 percent of the value of the fund.

(6) *Reciprocal cross holdings in the capital of financial institutions.* A supervised insurance organization must deduct from the building block parent's company available capital any investment(s) by the building block parent in the capital of unaffiliated financial institutions that it holds reciprocally, where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise intend to hold each other's capital instruments, to the extent that such investment(s) would otherwise be accretive to the building block parent's building block available capital.

(d) *Limits on certain elements in building block available capital of top-tier depository institution holding companies.*

(1) *Investment in capital of unconsolidated financial institutions.* (A) A top-tier depository institution holding company must deduct, from its building block available capital, any accreted capital from an investment in the capital of an unconsolidated financial institution that is not an inventory company, that exceeds twenty-five percent of the amount of its building block available capital, prior to application of this adjustment, excluding tier 2 capital instruments. For purposes of this paragraph, the amount of an investment in the capital of an

unconsolidated financial institution is calculated in accordance with § 217.22(h), except that a separate account asset or associated guarantee is not an indirect exposure.

(B) The deductions described in paragraph (d)(1)(A) of this section are net of associated deferred tax liabilities in accordance with § 217.22(e).

(2) *Limitation on tier 2 capital instruments.* A top-tier depository institution holding company must deduct any accretions from tier 2 capital instruments that, in the aggregate, exceed the greater of:

(i) 62.5 percent of the amount of its building block capital requirement; and  
(ii) The amount of instruments subject to paragraphs (e) or (f) of this section that are outstanding as of the submission date.

(e) *Treatment of outstanding surplus notes.* A surplus note issued by any company in a supervised insurance organization prior to November 1, 2019, is deemed to meet the criteria in paragraphs (a)(1)(iii) and (vi) of this section if:

(1) The surplus note is a company capital element for the issuing company;  
(2) The surplus note is not owned by an affiliate of the issuer; and  
(3) The surplus note is outstanding as of the submission date.

(f) *Treatment of certain callable instruments.* Notwithstanding the criteria under paragraph (a)(1) of this section, an instrument with terms that provide that the instrument may be called earlier than five years upon the occurrence of a rating event does not violate the criterion in paragraph (a)(1)(v) of this section, provided that the instrument was a company capital element issued prior to January 1, 2014, and that such instrument satisfies all other criteria under paragraph (a)(1) of this section.

(g) *Board approval of a capital instrument.*

(1) A supervised insurance organization must receive Board prior approval to include in its building block available capital for any building block instrument (as listed in this section), issued by any company in the supervised insurance organization, unless the instrument:

(i) Was a company capital element for the issuer prior to May 19, 2010, in accordance with the applicable capital framework that was effective as of that date and the underlying instrument meets the criteria to be a qualifying capital instrument (as defined in paragraph (a) of this section); or  
(ii) Is equivalent, in terms of capital quality and ability to absorb losses with respect to all material terms, to a

company capital element that the Board determined may be included in regulatory capital under this subpart pursuant to paragraph (g)(2) of this section, or may be included in the regulatory capital of a Board-regulated institution pursuant to § 217.20(e)(3).

(2) After determining that an instrument may be included in a supervised insurance organization's regulatory capital under this subpart, the Board will make its decision publicly available, including a brief description of the material terms of the instrument and the rationale for the determination.

\* \* \* \* \*

## PART 252—ENHANCED PRUDENTIAL STANDARDS (REGULATION YY)

■ 7. The authority citation to part 252 continues to read as follows:

**Authority:** 12 U.S.C. 321–338a, 481–486, 1467a, 1818, 1828, 1831n, 1831o, 1831p–l, 1831w, 1835, 1844(b), 1844(c), 3101 *et seq.*, 3101 note, 3904, 3906–3909, 4808, 5361, 5362, 5365, 5366, 5367, 5368, 5371.

### Subpart B—Company-Run Stress Test Requirements for Certain U.S. Banking Organizations with Total Consolidated Assets over \$10 Billion and Less Than \$50 Billion

■ 8. Section 252.13 is amended by revising paragraphs (b)(1)(ii) to read as follows:

#### § 252.13 Applicability.

\* \* \* \* \*

(b) \* \* \*

\* \* \* \* \*

(ii) Any savings and loan holding company with average total consolidated assets (as defined in § 252.12(d)) of greater than \$10 billion, excluding companies subject to part 217, subpart J of this chapter; and"

\* \* \* \* \*

**Editorial Note:** The following Exhibit will not publish in the Code of Federal Regulations.

#### Exhibit

**Editorial Note:** This section will not publish in the Code of Federal Regulations.

### Capital Requirements for Insurance Depository Institution Holding Companies Comparing Capital Requirements in Different Regulatory Frameworks

#### Preface

The Board of Governors of the Federal Reserve System is responsible for protecting the safety and soundness of depository institutions affiliated with

holding companies. This responsibility requires regulating the capital of holding companies of groups that conduct both depository and insurance operations.<sup>1</sup> Unfortunately, the insurance and banking sectors do not share any common capital assessment methodology. Existing capital assessment methodologies are tailored to either banking or insurance and unsuitable for application to the other sector.<sup>2</sup>

The Board proposes relying on these existing sectoral capital assessment methodologies to assess capital for most holding companies that own both insured depository institutions and insurers. In this proposed approach, capital requirements would be aggregated across sectors to calculate a group-wide capital requirement. Just as adding money denominated in different currencies requires exchange rates, meaningfully aggregating capital resources and requirements calculated under different regulatory frameworks requires some translation mechanism between them. We refer to this process of translating capital measures between regulatory frameworks as “scaling.”

### Executive Summary

This white paper examines scaling. Scaling has not previously been the subject of academic research, and industry practitioners don't agree on the best methodology.

This paper introduces a scaling method based on historical probability of default (PD) and explains why the Board's proposal uses this approach. This method uses historical default rates as a shared economic language to enable translation. Concretely, scalars pair solvency ratios that have identical estimated historical insolvency rates. An analysis of U.S. data produces the simple scaling formulas below.

NAIC Authorized Control Level Risk Based Capital = .0106 \* Risk Weighted Assets  
 NAIC Total Adjusted Capital = Bank Tier 1 Capital + Bank Tier 2 Capital – .063 \* Risk Weighted Assets

This paper also compares the PD method and alternatives, including those suggested by commenters in response to the Board's advance notice of proposed rulemaking (ANPR).<sup>3</sup> While other implementable methods make

broad assumptions regarding equivalence, the historical PD method only assumes that companies have equivalent financial strength when defaulting.<sup>4</sup> The major disadvantage of the PD approach is that it needs extensive data. Plentiful data exists on U.S. markets but not many international markets. Because of this and because the Board's current population of supervised insurance groups has immaterial international insurance operations, scalars for other jurisdictions were not developed.

### Key Concepts

- Scaling can be simplified into the calculation of two parameters: (1) A required capital scalar and (2) an available capital scalar.
- There are at least three considerations of importance in assessing the scaling methods: (1) Reasonableness of the assumptions, (2) ease of implementation, and (3) stability of the parameterization.
- Our analysis identifies a trade-off between the reasonableness of a methodology's assumptions and the easiness of its implementation. Easily producing stable results generally requires bold assumptions about the comparability of regulatory frameworks.
- The Board's recommended scaling approach (PD method) relies on an analysis of historical default rates in the different regulatory frameworks.

### Introduction

In its ANPR of June 2016, the Board proposed a building block approach (BBA) for regulating the capital of banking organizations with substantial insurance operations.<sup>5</sup> For these institutions, the building block approach would first calculate the capital resources and requirements of its subsidiary institutions in different sectors. After making adjustments that provide consistency on key items and ensure risks are not excluded or double counted, the building blocks would be scaled to a standard basis and then aggregated to calculate enterprise-level available capital and required capital.

Building blocks originate in regulatory frameworks, referred to as “regimes,” with different metrics and scales. They need to be standardized before they can be stacked together. We refer to the process of translating capital measures from different regimes into a

common standard as “scaling.” Based on the firms that would be subject to the proposed rule currently, only two regimes would be material: the regime applicable to U.S. banks and the regime applicable to U.S. insurers, which is the National Association of Insurance Commissioner (NAIC) Risk-Based Capital (RBC) requirements.<sup>6</sup> These regimes use starkly different rules, accounting standards, and risk measures. While both the banking and insurance risk-based capital standards use risk factors or weights to derive their capital requirements, they differ in the risks captured, the risk factors used, and the base measurement that is multiplied by these factors. In banking, the regulatory risk measure applies risk weights to assets and off-balance-sheet activities. This produces risk-weighted assets (RWA). In insurance, the reported risk metric—“Authorized Control Level Risk Based Capital Requirement (ACL RBC)” —uses a different methodology. Among other differences, this methodology emphasizes risks on liabilities and gives credit for diversification between assets and liabilities.

### Scaling Framework and Assessment Criteria

Scaling translates available capital (AC) and required capital (RC) between two different regimes. We refer to the original regime as the applicable regime and the output regime—under which comparisons are ultimately made—as the common regime. The Board's proposal uses NAIC RBC as the common regime.

The scaling formulas below provide a generalized scaling framework with two parameters and enough flexibility to represent our proposal and all scaling methods suggested by commenters. One parameter, which we refer to as the required capital or  $S_{RC}$ , applies to RC in the applicable regime and captures the average difference in the “stringency” of the regimes' RC calculations and the units used to express the RC. We assume that differences in stringency between regimes' risk measurements can be modeled by a single multiplicative factor. The second parameter, which we refer to as the available capital scalar or  $S_{AC}$ , adjusts for the relative conservatism of the AC. This parameter represents the additional amount of conservatism in the calculation of AC in the applicable regime relative to the common regime. Unlike the multiplicative scaling of

<sup>1</sup> 12 U.S.C. 5371.

<sup>2</sup> Insurance methodologies are also generally country specific.

<sup>3</sup> Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 FR 38,631 (June 14, 2016), <https://www.gpo.gov/fdsys/pkg/FR-2016-06-14/pdf/2016-14004.pdf>.

<sup>4</sup> See the *Historical Probability of Default* Section for details of this method. An empirical check on the assumption regarding companies defaulting at similar levels of financial strength can be found at [reasonableness of assumptions discussion].

<sup>5</sup> This approach is expanded upon in the Board's proposed rule.

<sup>6</sup> Where material, unregulated financial activity would also be assessed under one of those regimes and aggregated.

required capital, we assume available capital is an additive adjustment that varies based on a company's risk. This allows the issuance of additional capital instruments, such as common stock, to increase available capital equally in both regimes, while still allowing for the regimes to value risky assets and

liabilities with differing degrees of conservatism.

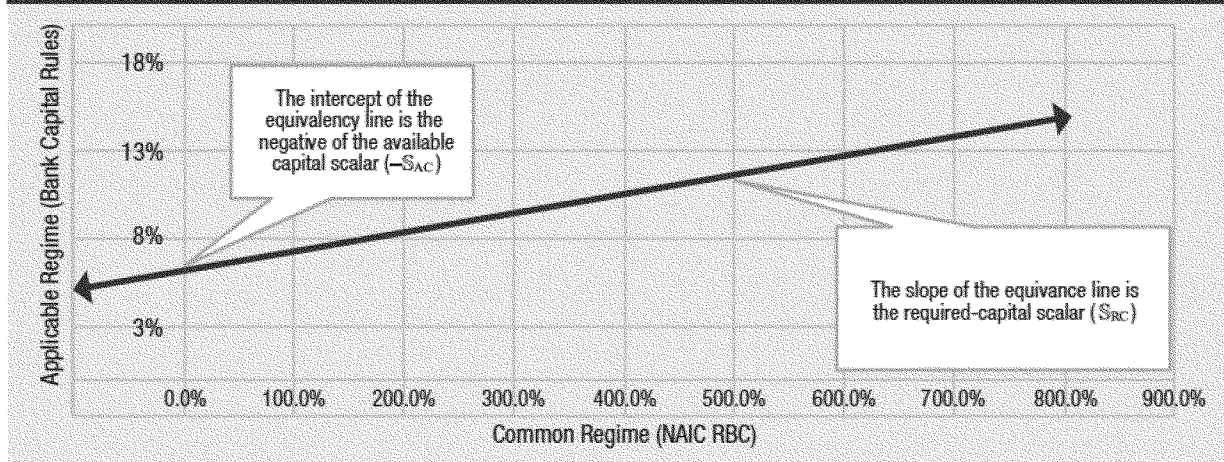
$$RC_{\text{common}} = S_{RC} * RC_{\text{applicable}}$$

$$AC_{\text{common}} = AC_{\text{applicable}} + S_{AC} RC_{\text{applicable}}$$

These scaling parameters also have graphical interpretations that illustrate their meaning. An equivalency line

between the solvency ratios of regimes (AC divided by RC) has a slope of  $S_{RC}$  and intercept of  $-S_{AC}$  when plotted with the common regime as the x-axis. Figure 1 depicts this relationship, and appendix 1 shows a full derivation of this graphical interpretation.

**Figure 1. Illustration of hypothetical equivalence line**



In this two-parameter framework, a scaling methodology represents a way of calculating  $S_{RC}$  and  $S_{AC}$ . Possible scaling methodologies range from making very simple assumptions about equivalence to using complex methods involving data to estimate these relationships. There are at least three considerations of importance in assessing the scaling methods. We identify these as the reasonableness of the assumptions, ease of implementation, and stability of the parameterization.

The first of these is the reasonableness of the assumptions. Methodologies that make crude assumptions likely won't produce accurate translations. Accurate translations between regimes enable a

more meaningful aggregation of metrics, thus allowing the Board to better assess the safety and soundness of institutions and ultimately to better mitigate unsafe or unsound conditions.

Another important consideration is the method's ease of implementation. The most theoretically sound methodology would lack practical value if it cannot be parameterized.

A final consideration is the stability of their parameterization—the extent to which changes in assumptions or data affect the value of the scalars. Scaling should be robust across time unless the underlying regimes change. This stability provides predictability to firms and facilities planning.

#### Historical Probability of Default

A sensible economic benchmark for solvency ratios is the insolvency or default rates associated with them, and this method uses these rates as a Rosetta stone for translating ratios between regimes. For example, under this method a bank solvency ratio that has historically resulted in a 5 percent PD translates to the insurance solvency ratio with an estimated 5 percent PD.<sup>7</sup>

Mechanically, this calculation uses (logistic) regressions to estimate the relationship between the solvency ratios and default probability.<sup>8</sup> Setting the logit of PD in both regimes equal to each other gives an equation that relates the solvency ratios in the two regimes as shown below.

$$\begin{aligned} a_{\text{applicable}} + b_{\text{applicable}} * \frac{AC_{\text{applicable}}}{RC_{\text{applicable}}} &= \frac{PD}{1 - PD} \\ &= a_{\text{common}} + b_{\text{common}} * \frac{AC_{\text{common}}}{RC_{\text{common}}} \end{aligned}$$

In these formulas, “b” represents the slope of the estimated relationship between a regime's solvency ratio and

(logistic) default probability and “a” represents the intercept. Simplifying

this equation produces the equations below, as demonstrated in appendix 2.

<sup>7</sup> We need the PD to be monotonic on the financial strength ratios for this approach to produce a single mapping.

<sup>8</sup> The logistic transformation is used because the regression involves probabilities. If ordinary least squares were used instead, estimated probabilities

of default could be lower than 0 percent or higher than 100 percent for some solvency ratios.

$$S_{RC} = \frac{b_{common}}{b_{applicable}}$$

$$S_{AC} = \frac{a_{applicable} - a_{common}}{b_{applicable}}$$

This section will illustrate the approach and describe how it was used to derive the proposed scalars for U.S. banking and U.S. insurance. The approach will then be discussed in terms of the three identified considerations for scaling methods. This analysis reveals that the method generally can provide an accurate and stable translation of regimes for which robust data are available, which is why the Board has proposed to rely on the method for setting the scalar between the U.S. banking regime and the U.S. insurance regime.

#### *Application to U.S. Banking and Insurance*

To apply this approach, we obtained financial data on depository institutions and insurers. Insurance financial data came from statutory financial statements. Bank data came from year-end Call Reports.<sup>9</sup> The Call Report, which is filed by the operating depository institutions, provides the best match for the insurance data, which is only for the operating insurance companies as of year end. The usage of operating company data also comports with the Board's proposed grouping scheme, which would be at a level below the holding company. For the solvency ratios, we used ACL RBC for insurers because it can easily be calculated from reported information and serves as the basis for state regulatory interventions in the NAIC's Risk-Based Capital for Insurer's Model Act.<sup>10</sup> Many different solvency ratios are calculated for banks. We used the total capitalization ratio. This broad

regulatory capital ratio is the closest match in banking for ACL RBC for insurance in terms of which instruments are included.<sup>11</sup>

Several filters were applied to the data. Only data after 1998 and before 2015 were used based on data availability, state adoption of insurance risk-based capital laws, and the three-year default horizon discussed below.<sup>12</sup> Very small entities—those with less than \$5 million in assets—were excluded from both sectors. These firms had total asset size only sufficient to pay a handful of claims or large loan losses; their default data appeared unreliable and could not generally be corroborated by news articles or other sources. Organizations with very high and low capital ratios were also excluded (insurance ratios < -200% or >1500% ACL RBC; banks with total capitalization <3% or >20% RWA). Additionally, carriers not subject to capital regulation and those that fundamentally differ from other insurers were excluded. These included captive insurers (for example, an insurer owned by a manufacturer that insures only that manufacturer); government-sponsored enterprises (for example, workers compensation state funds); and monoline group health or medical malpractice insurers. P&C fronting companies were also removed. Summary statistics showing the magnitude of these exclusions can be seen in appendix 3.

We also obtained default data for the banking and insurance sectors. A three-year time horizon for defaults was used in both regimes to balance the competing considerations of wanting to observe a reasonable number of defaults beyond the most weakly capitalized companies and maximizing the number of data points that could be used in the regression.<sup>13</sup> Because of the Board's

supervisory mission, "default" was defined as ceasing to function as a going concern due to financial distress. This definition did not always align with the point of regulatory intervention or commonly available data. Consequently, existing regulatory default data sets were supplemented to best align with the default definition.<sup>14</sup>

Insurance default data were obtained from the NAIC's Global Insurance Receivership Information Database (GRID).<sup>15</sup> Because some insurers cease to function as going concerns without being reported in this data set, which is voluntary and impacted by confidentiality, a supplemental analysis was also performed.<sup>16</sup> An insurer was also considered to be in default if it fell below the minimum capital requirement and (1) had its license suspended in any state, (2) was acquired, or (3) discontinued underwriting new businesses. Extensive checks were performed on random companies as well as all outliers (those with high RBC ratios that default and low RBC ratios that do not default). This resulted in the development of criteria above and the identification of some additional defaults based on news articles and other data sources.<sup>17</sup>

For banking organizations, default data were extracted from the FDIC list of failures.<sup>18</sup> For this analysis, banking organizations were also considered to be

<sup>14</sup> An empirical check on the reasonableness of these assumptions and alignment can be found on in the section below on reasonableness of assumptions.

<sup>15</sup> The NAIC's GRID database can be accessed at <https://i-site.naic.org/grid/gridPA.jsp>.

<sup>16</sup> The NAIC describes GRID as "a voluntary database provided by the state insurance departments to report information on insurer receiverships for consumers, claimants, and guaranty funds" at <https://eapps.naic.org/cis/>. See also NAIC, GRID FAQs, available at <https://i-site.naic.org/help/html/GRID%20FAQs.html> ("In some states a court ordered conservation may be confidential.")

<sup>17</sup> A handful of companies were identified as no longer being going concerns based on qualitative sources such as news articles, rating agency publications, or in notes to the financial statements that could not easily be applied to all companies. Additionally, several companies were removed who appear to have ceased functioning as going concerns at a time prior to the sample based on the volume of premiums written. Two companies were dropped from the data set for having aberrant data.

<sup>18</sup> See <https://www.fdic.gov/bank/individual/failed/banklist.csv>.

<sup>9</sup> Call report data were downloaded from the publicly available Federal Financial Institutions Examination Council database and supplemented with internal data. See "Bulk Data Download," Federal Financial Institutions Examination Council, <https://cdr.ffiec.gov/public/PWS/DownloadBulkData.aspx>.

<sup>10</sup> The BBA would not be impacted by using different multiples of these amounts because the required capital scalar is multiplicative. For instance, Company Action Level (CAL) RBC is two times ACL RBC. If this were used in the scaling regressions, all insurance solvency ratios would be cut in half. This would produce corresponding changes to the scaling equations and required capital ratios, but the overall capital requirement would remain constant when expressed in terms of dollars. Similarly, the rule would not be impacted by using some fraction of risk-weighted assets (for example, 8 percent) for banks.

<sup>11</sup> The proposed rule uses limits and other adjustments to further align the definition of regulatory capital between the two regimes and ensure sufficient quality of capital.

<sup>12</sup> For state adoption dates, see "Risk Based Capital (RBC) for Insurers Model Act," National Association of Insurance Commissioners, <http://www.naic.org/store/free/MDL-312.pdf>, 15–20.

<sup>13</sup> The impact of this assumption was analyzed and is discussed in the context of the stability of the method's parameterization at in the subsection Stability of Parameterization.

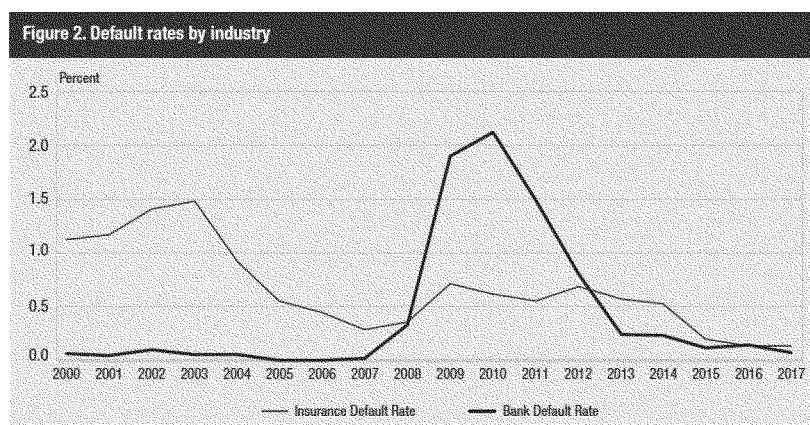
in default if they were significantly undercapitalized (total capitalization below 6 percent of RWA) and did not recover, which might occur in a voluntary liquidation. Additionally, banking organizations with total capitalization ratios under 6 percent of RWA for multiple years were manually checked for indications that operations ceased. The different default rates by industry are shown in table 1 and figure 2.

TABLE 1—DEFAULT RATES BY INDUSTRY

Year	Insurance defaults	Bank defaults
2000 .....	23	4
2001 .....	23	3
2002 .....	27	6
2003 .....	28	3
2004 .....	17	3
2005 .....	10	0
2006 .....	8	0
2007 .....	5	1
2008 .....	6	19

TABLE 1—DEFAULT RATES BY INDUSTRY—Continued

Year	Insurance defaults	Bank defaults
2009 .....	12	112
2010 .....	10	122
2011 .....	9	80
2012 .....	11	40
2013 .....	9	12
2014 .....	8	11
2015 .....	3	5
2016 .....	2	6
2017 .....	2	3



To estimate the probabilities of default from these data, we used a logistic regression, which is commonly used with binary data, to estimate the

parameters  $a$  and  $b$  in the equation below. The regression used cluster-robust standard errors with clustering by company. Additional details about

these regressions can be found in table 2 with a discussion of their goodness of fit and robustness following in the sections below.

$$\text{logit}(PD_i) = a + b * \left(\frac{AC}{RC}\right)_i + \varepsilon_i$$

The parameters on the P&C and life insurance regressions were analyzed separately because the regimes are

distinct; however, the regression results were very close to each other with no significant statistical difference.<sup>19</sup> The

results of the combined insurance and banking regressions are displayed in table 2.

TABLE 2—INSURANCE AND BANKING REGRESSIONS

	Banking	P&C insurance	Life insurance	Combined insurance
Slope (b) .....	−66.392	−0.714	−0.662	−0.704
Robust Std. Err .....	(1.854)	(0.052)	(0.102)	(0.046)
Intercept (a) .....	3.723	−0.402	−0.602	−0.432
Robust Std. Err .....	(0.201)	(0.178)	(0.440)	(0.164)
Observations .....	92,215	21,031	6,862	27,893
Pseudo R <sup>2</sup> .....	24.9%	23.3%	20.3%	23.3%

Using the formulas from the start of this section that relate logistic regression output to scaling parameters,  $S_{RC} = 1.06\%$  and  $S_{AC} = 6.3\%$ .

These results appear reasonable and suggest that the banking capital requirement is approximately equivalent to the insurance capital

requirement but that the regimes differ in their structure. The insurance regime's conservative accounting rules lead to a conservative calculation of

<sup>19</sup> Because the two slope values are very close (−.662 and −.714), the p value of a test of differences is close to 50 percent). The constant

terms show larger differences (−.402 vs. −.602) and could indicate that P&C companies have slightly less balance sheet conservatism compared

with life insurers; however, the difference is not statistically significant either (p ~ .44).



available capital. These rules set life insurance reserves at above the best-estimate level, don't allow P&C carriers to defer acquisition expenses on policies, and don't give any credit for certain types of assets. Because of this conservative calculation of available capital, the required capital calculation is relatively lower with ACLR RBC translating to only about 1 percent of RWA.

#### *Reasonableness of Assumptions*

Because regulators design solvency ratios to identify companies in danger of failing, default rates are a natural benchmark for assessing them economically. Comparing solvency ratios based on this benchmark is more reasonable than the alternatives, but it does have limitations.

One important limitation is that definitions of default across sectors may be difficult to compare. To some extent, defaults are influenced by regulatory actions, which are entwined with the underlying regime itself. Although adjustments can be made (as we do with our default definition in the U.S. markets), there is likely still some endogeneity. However, defaults still provide a more objective assessment of the regime than the alternatives discussed in the *Review of Other Scaling Methods* under which these differences would be assumed not to exist. For instance, one primary alternative would be to scale by assuming the equivalency of regulatory intervention points. Another would assume that the accounting is comparable.

As a test of the comparability of the default definitions, we estimated each

sector's loss given default. If the default definitions in both sectors were equivalent economically, then the cost of these defaults should also be close. Based on data from the FDIC, the average bank insolvency in the period studied was approximately 10.7% of assets with a median of 22.4%. The median is significantly higher than the mean because of the very large Washington Mutual failure. Excluding Washington Mutual, the mean insolvency cost was 18.7%. We estimated the cost of insurance insolvencies by comparing the cost to insurance guarantee fund assessments during the sample period with the assets of insurers that defaulted using our definition. This produced an estimate of insolvency costs of 16.9% of net admitted assets. This is between the median and mean of the bank distribution and close to the bank mean when Washington Mutual is excluded. This supports our assumption that institutions identified as defaulting can be considered to have comparable financial strength.

Historical insolvency rates also do not reflect regime changes and can be influenced by government support. In the application to U.S. banking and insurance, no adjustment was made for these factors, which are difficult to quantify and would likely offset each other to some extent over the period studied. Banking organizations have been more affected by past government support, which might imply the regressions underestimate PD, but there has recently been a significant tightening of the regime after the 2008 financial crisis, which would have an

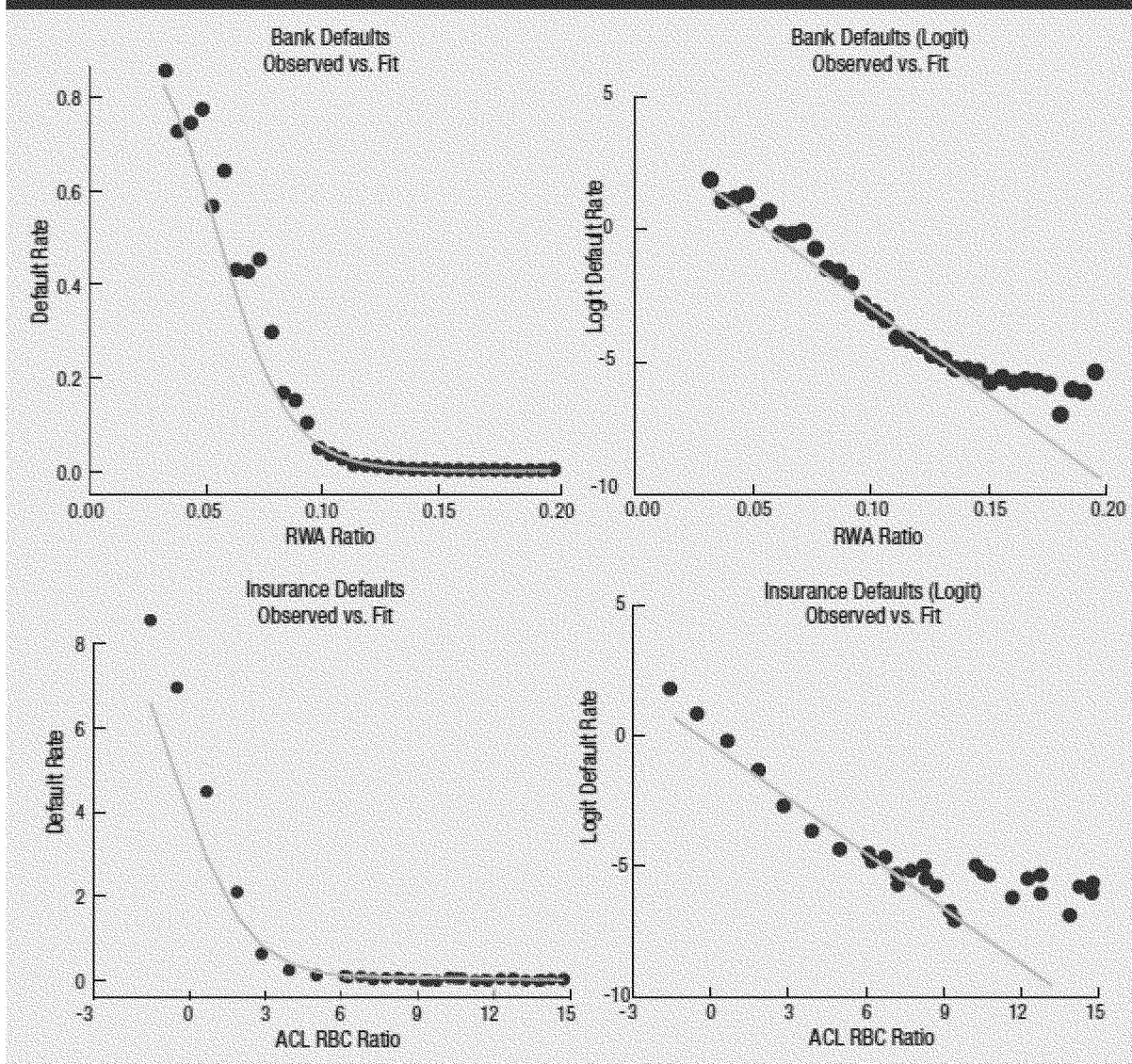
opposite effect.<sup>20</sup> Additionally, support from the major government programs during the financial crisis depended on the firm being able to survive without it. On the insurance side, government support during the crisis was much less extensive, but there has also not been a similar recent strengthening of the regime.<sup>21</sup> To the extent the regimes were to have material, directional changes, this assumption would be less reasonable and likely need to be revisited in a future study.

An additional limitation is the assumption of linearity in the relationship between solvency ratios and default probabilities after the logistic transformation. Figure 3 shows the goodness of fit of the PD estimation for U.S. banking and insurance. The blue dots represent actual observed default rates. The light red line represents the output from the regressions discussed above. The figures on the left are the same as those on the right after the logistic transformation.

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<sup>20</sup> Since the crisis, a number of reforms have been made to the banking capital requirements in the United States, including a reduction in the importance of internal models and additional regulation of liquidity. These reforms would make banks less likely to default at a given total capitalization ratio.

<sup>21</sup> The major changes to insurance regulation following the crisis have been the introduction of an Own Risk and Solvency Assessment along with some enterprise-wide monitoring. These would make insurers safer at a given capital ratio. The recently passed principle-based reserving requirements, which generally lowered reserves on many insurance products, would have the opposite effect.

**Figure 3. Goodness of fit graphs of historical PD regressions**

The regressions produce a reasonably good fit to the available data, but the linear fit breaks down for very highly capitalized companies in both sectors (see blue circles). Consistent with other research, beyond a certain point, capital does not appear to have a large impact on the probability of a company defaulting. We considered a piece-wise fit to address this issue, but decided against it for three reasons. First, this issue has little practical impact because it only affects very strongly capitalized companies. Differentiating between these companies is not the focus of the capital rule. Second, a piece-wise function would drastically increase the complexity of the process. Simple scaling formulas can be derived if a single logistic regression is used for

each.<sup>22</sup> Translating piece-wise regressions into workable scaling formulas would require simplifications that could outweigh any otherwise improved accuracy. Third, the required number of parameters needed to fit a piece-wise model would more than double and introduce additional uncertainty about the parameters.

#### *Ease of Implementation*

The biggest disadvantage of this approach is data availability. The approach requires a large number of default events to calibrate the impact of the solvency ratio accurately. Although these data are available on the currently needed regimes, they may not be

available in other regimes for which scalars could be needed in the future.

#### *Stability of Parameterization*

The parameter estimates appear stable and robust. As one basic measure of stability and robustness, we estimated the standard error of the scaling estimates by simulating from normal distributions with the mean of the underlying regression parameters and standard deviation of their standard error. This measure indicated a 95 percent confidence interval of between .010 and .013 for  $S_{RC}$  and between -.054 and -.071 for  $S_{AC}$ . This confidence interval is a fairly tight range given the spread of other methods.

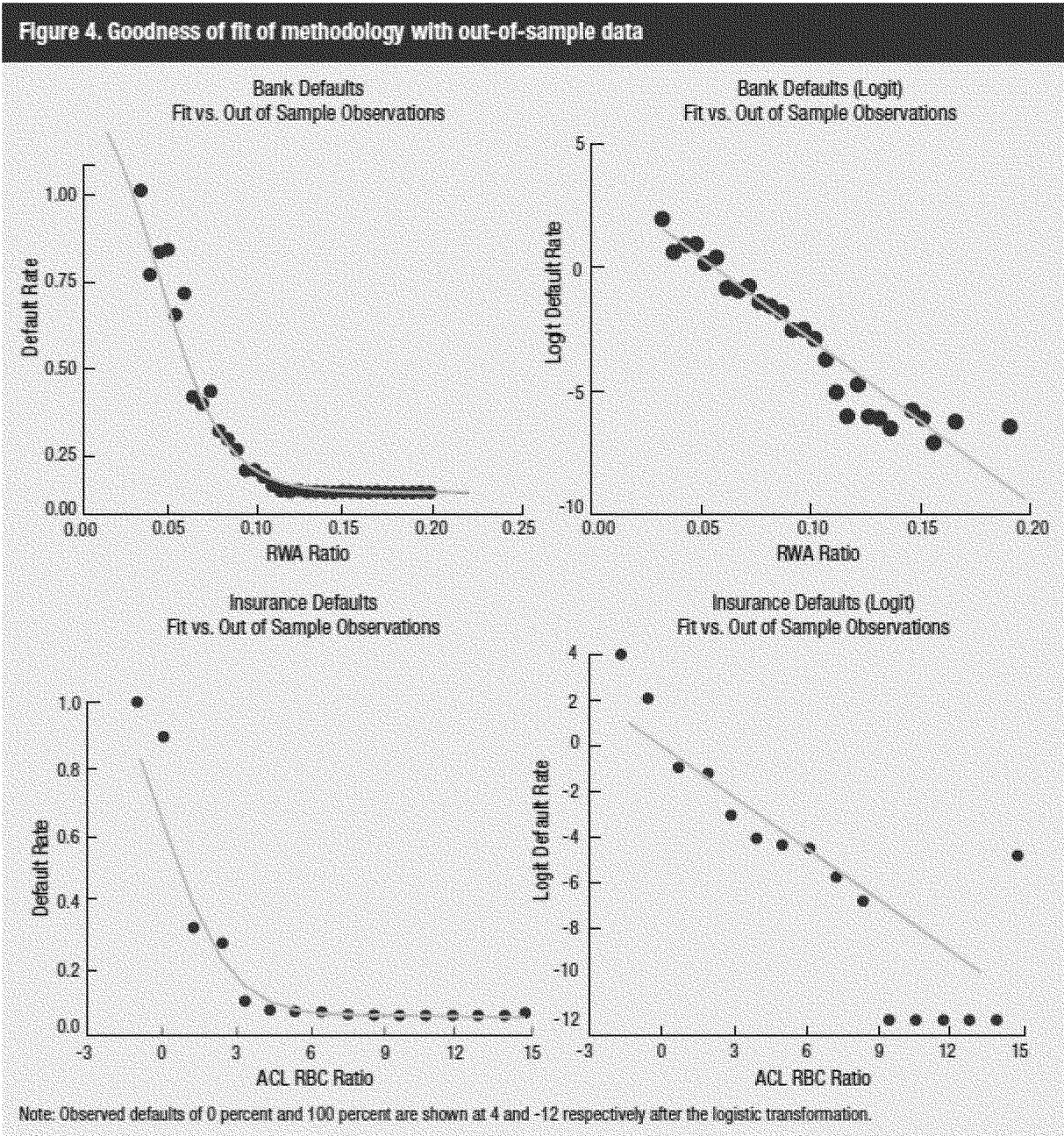
We also tested the robustness of the methodology on out of sample data. To do this, we split the sample at the year

<sup>22</sup> See appendix 2 for the derivation of the simple formulas if no piece-wise regression is used.

2010. Data from prior to 2010 was used to parameterize the model while data from 2010 and subsequent years was

used to assess the goodness of fit. Figure 4 displays the results of this test. The model performs fairly well on this test.

The goodness of fit on the out of sample data appears comparable to those within the entire data set.



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We also tested the parameterization for sensitivity to key assumptions, which would not be captured by the estimated standard errors. A description of these tests and the resulting scalars

are displayed in table 3. We also attempted to test the impact of the exclusion of some data, including companies with very high or very low solvency ratios, but we found that the regression showed little relationship

between the capital ratios and default probabilities in both regimes when outlier entities that have ratios that are orders of magnitude apart from typical companies are included.

TABLE 3—RESULTS OF ROBUSTNESS TESTS OF HISTORICAL PD METHOD

Name	Description	AC scalar (percent)	RC scalar (percent)
Baseline .....	Assumptions used in the proposal .....	–6.26	1.06
Excluding firms under \$100 million .....	Firms with a largest size of less than \$100 million in assets are excluded.	–6.51	1.17
Wider solvency ratio bounds .....	Insurance bounds are to allow ratios between –300% to 2000% of ACL RBC to be used in the regression. Banking bounds are similarly moved to 2% and 30% of RWA.	–6.06	1.10
Largest half of companies .....	The smallest 50% of companies as measured by their peak total asset size are excluded from both the banking and insurance samples.	–5.72	2.21
1 year default definition .....	A one year default horizon is used in place of the baseline three year window.	–6.15	0.96
No crisis .....	The financial crisis (2009–2010) is excluded from the sample by using a one-year default horizon and excluding observations from year end 2008 and year-end 2009.	–5.60	0.91

### Summary and Conclusion

The use of historical default probabilities can produce a reasonable scalar for U.S. banking and insurance. The primary disadvantage is the data required, which may not be available for other jurisdictions. Because this method has a relatively robust parameterization, the parameters would not need to be updated on a set schedule and could be instead be revisited if new data or conditions suggest a change is warranted.

### Review of Other Scaling Methods

Other methods exist for calibrating the scaling parameters. This section gives a description of these methods and compares them to the historical PD method based on the desired characteristics described before. The methods are arranged roughly in order of their ease of parameterization. At one end of the spectrum, not scaling is very

simple, but it is not likely to produce an accurate translation. At the other end of the spectrum, scaling based on market-derived probabilities of default and scaling based on a granular analysis of each regime's methodologies have theoretical advantages but cannot be parameterized even for U.S. banking and U.S. insurance. Between these extremes, some methods can be parameterized but generally have less reasonable assumptions than the historical PD method.

### Not Scaling

One scaling method would be to assume that no scaling is required, as might be tempting for solvency ratios of the same order of magnitude. This method would be equivalent to assuming that  $S_{ac}$  were equal to zero and  $S_{rc}$  were equal to one.

Although this approach would be very stable and not require parameterization, the assumption

generally appears unreasonable because of the many differences between regimes. A typical ACL RBC ratio would be hundreds of percent. The average bank operates with an RWA ratio near 16 percent. Furthermore, although the numerators in these ratios might be deemed as comparable under certain circumstances, the denominators are conceptually very different. The denominator in insurance is required capital; the denominator in banking is risk-weighted assets.

### Scaling by Interpolating Between Assumed Equivalent Points

This category of methods would take two assumed equivalent solvency ratios and use interpolation between these to produce an assumed equivalence line and the implied scaling parameters. The methods in this category would vary primarily in terms of how they derive the assumed equivalency points.

TABLE 4—ANALYSIS OF POTENTIAL SIMPLE EQUIVALENCY ASSUMPTIONS

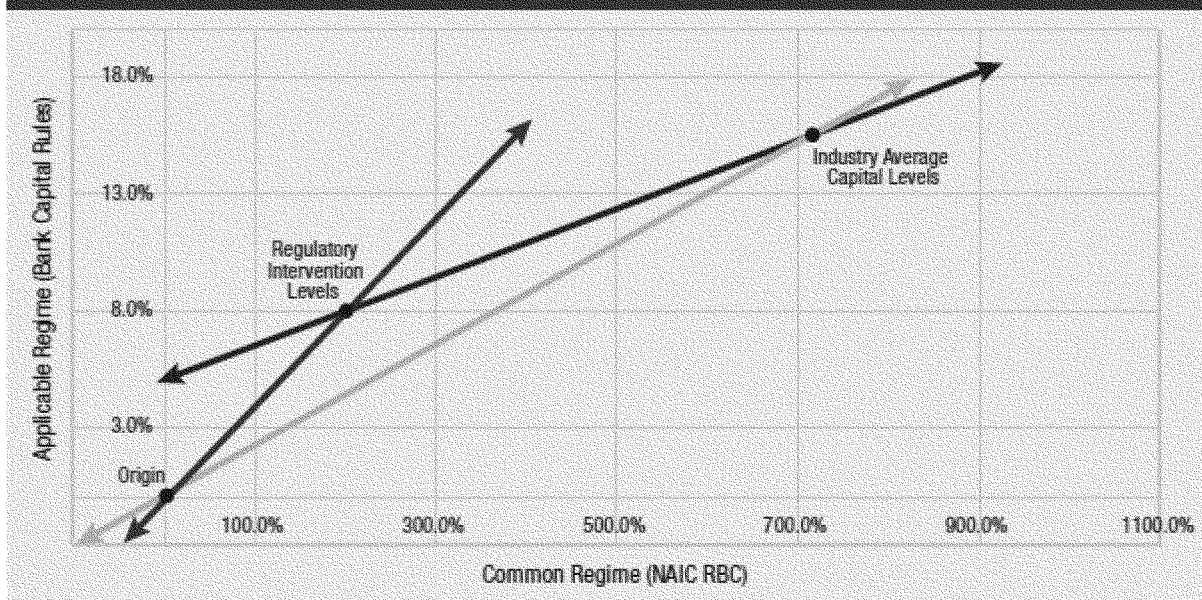
Assumed equivalence	Reasonableness of assumptions	Ease of parameterization	Stability of parameterization
Available capital calculations.	Regimes are known to differ materially in how they compute key aspects of available capital including insurance reserves.	Parameterized by assumption.	Very stable by assumption.
Regulatory intervention levels.	Regulatory objectives vary, which could justify intervening at different levels.	Very easy .....	Very stable because regulatory intervention points do not frequently change.
Industry average capital levels.	Corporate structure considerations in each of these industries are very different, and the average financial strength is unlikely going to be comparable.	Easy .....	Least stable—the industry's capital ratio frequently changes and the ratio of U.S. industry averages has varied by almost 50% between 2002 and 2007.

It is possible to mix and match from these assumptions to produce a scaling methodology as illustrated in figure 5. In this figure, each of the three assumptions is plotted as an assumed equivalence point. For example, an 8 percent level of bank capital and 200 percent of ACL RBC translate to

comparable regulatory interventions so (200 percent, 8 percent) is shown as the regulatory intervention equivalence point. An assumption that scaling is not required on available capital translates to equivalence at (0 percent, 0 percent) because a company with no available capital in one regime would also have

no available capital after scaling. Three different lines are illustrated which show the three different ways these assumptions could be combined to produce scaling methodology.

Figure 5. Interpolation methods illustration



Most commenters on the ANPR suggested one of these methods, but commenters were split as to which assumption was better. A plurality of commenters suggested not assuming equivalence in available capital calculations because, as the Board noted in the ANPR, regimes do differ significantly in how they calculate available capital. However, one disadvantage of this method is that the average capital levels in a regime may not always be available, so it might not be possible to parameterize it for all regimes.

It is also possible to add different adjustments to these methods. For instance, rather than directly using the regulatory intervention points, one could first adjust these to make them more comparable. To the extent that one knew that the regulatory intervention point was set at a given level (for example, 99.9 percent over 1 year vs. 99.5 percent over one year) then it would be possible to adjust the intervention point in one regime to move it to a targeted confidence level that aligns with another regime. However, given that these targeted calibration levels are more aspiration than likely to ultimately be supported by empirical data, this adjustment does not significantly improve the reasonableness of the underlying assumptions.

Some other adjustments could marginally improve the analysis. For instance, although it is plausible that industries in similarly developed economies could be similar, assuming

equivalence across starkly different economies is less reasonable. In particular, the level of general country risk within a jurisdiction is likely to affect both insurance companies and insurance regulators, and some adjustment for this could improve the method.

Although these adjustments do marginally improve the methods, methods in this category would still not be making as reasonable of assumptions as the historical PD method. We do not consider it appropriate to use any method in this category in setting the scalar between the Board's bank capital rule and NAIC RBC. This category of methods could, however, have utility where simple assumptions are needed to support calibration.

#### Scaling Based on Accounting Analysis

A different data-based method that was considered would use accounting data in place of default data. Under this method, the distribution of companies' income and surplus changes would be analyzed similarly to how the Board calibrated the surcharge on systemically important banks.<sup>23</sup> If companies routinely lost multiples of the regulatory capital requirement, the regulatory capital requirement likely is not stringent.

Turning this intuition into a scaling methodology requires an additional

assumption about equivalent ratios.<sup>24</sup> Numbers can be scaled to preserve the probability of having this ratio (or worse) after a given time horizon. For example, if we define insolvency as having assets equal to liabilities and assume this definition is comparable in both regimes, then we can scale capital ratios based on the probability of a loss larger than the capital ratio being observed. If historically  $x$  percent of banks have experienced losses larger than their current capital ratio over a given time horizon, then this ratio would be scaled to the insurance solvency ratio that  $x$  percent of insurers have observed losses larger than. A derivation of scaling formulas from these assumptions is contained in appendix 4.

Although this method appears more reasonable than the simple interpolation methods, the assumptions are not as sound as for the historical PD method. Although there is some endogeneity with defaults, there is much more with accounting data. Regimes differ greatly in how they calculate net income and surplus changes such that benchmarking against a distribution of these values may not bring the desired comparability. The additional assumption required on equivalence is also problematic as it would essentially require incorporating one of the

<sup>23</sup> Board of Governors of the Federal Reserve System, *Calibrating the GSIB Surcharge*, (Washington: Board of Governors, July 20, 2015), <https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf>.

<sup>24</sup> This parameter and assumption were not necessary in calibrating the surcharge on systemically important banks because that only depended on the change in default probability as capital changes, rather than the absolute magnitude of the default probability.



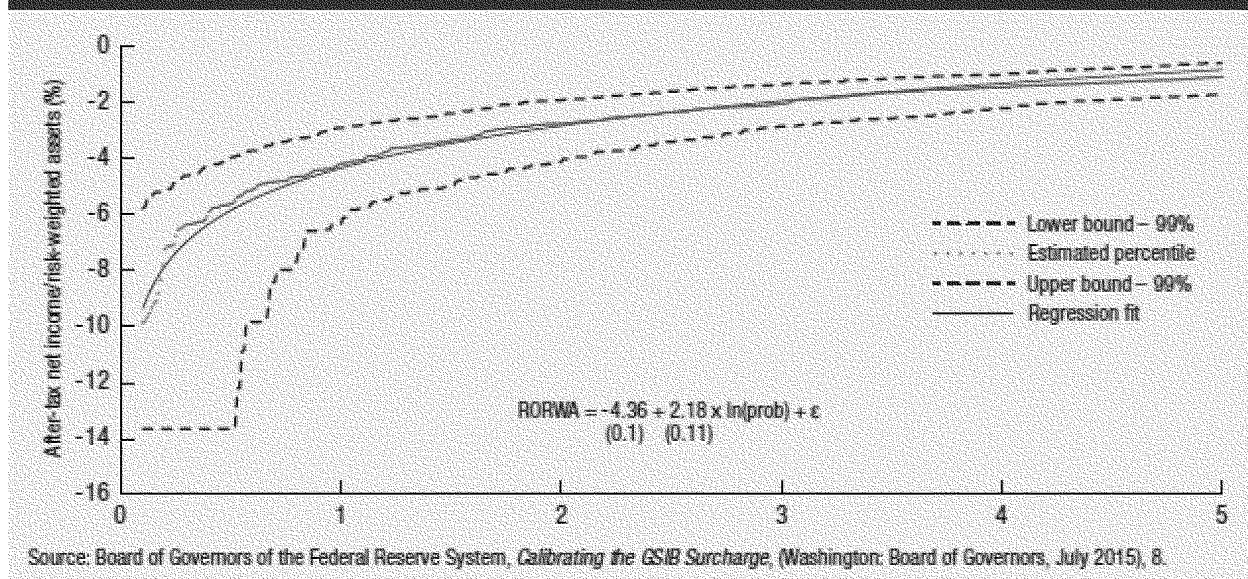
problematic assumptions discussed in the previous section on interpolation.

In terms of the ease of parameterization, the method ranks somewhere between the historical PD method and the simple methods based on interpolation. Income data are

plentiful relative to both historical default data and market-derived default data. This ubiquity of the data could allow for calibration of additional regimes and allow changes in regimes to be picked up before default experience emerges.

To parameterize this method for U.S. banking and insurance, we started with the distribution of bank losses discussed in the calibration of the systemic risk charge for banks (see figure 6).

**Figure 6. Returns on risk-weighted assets (RORWA) (bottom five percentiles, 50 largest BHCs in each quarter, 2Q87 through 5Q14)**



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To apply this method to insurance, historical data on statutory net income relative to a company's authorized control level were extracted from SNL. Data were collected on the 95 insurance groups with the relevant available data

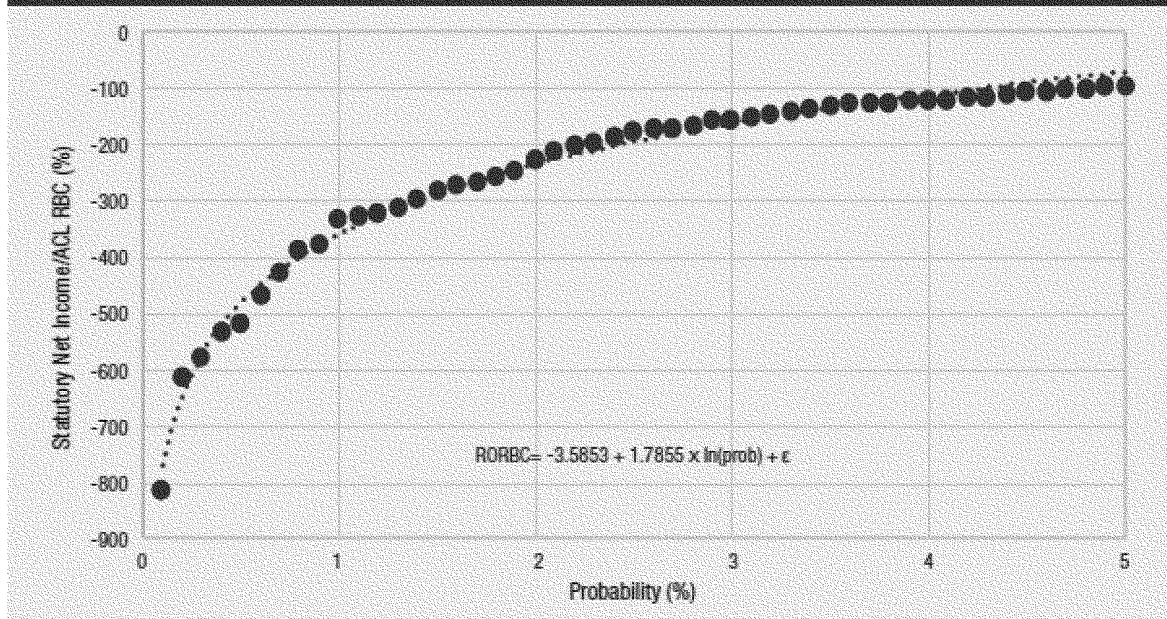
<sup>25</sup> Federal Reserve, *GSIB Surcharge*, at 8

in SNL and over \$10 billion in assets as of 2006.<sup>26</sup> Quarterly data points were used over the period of time for which

<sup>26</sup> Ninety-five groups met the size criteria, but three of these groups did not have RBC or income data and produced errors when attempting to pull the data. Two of these companies were financial guarantors.

they were available (2002 to 2016). A regression was then run on the estimated percentiles and log of the net income values to smooth the distribution and allow extrapolation. Figure 7 shows the distribution of ACL RBC returns resulting from this analysis.

Figure 7. Return on ACL RBC (bottom five percentiles)



Unlike with historical PD, an analysis of the top 50 life and P&C groups based on year-end 2006 assets under this method strongly suggested a different calibration. Historically, P&C carriers are significantly less likely than life carriers to experience large losses relative to their risk-based capital requirements. In 2008, nearly half the largest life insurance groups experienced losses that were above their authorized control level regulatory capital requirement. P&C insurers were much less likely to experience comparable losses. Table 5 shows the scalars produced when the NAIC RBC life regime is used as the base.

TABLE 5—SCALARS BASED ON ACCOUNTING ANALYSIS RESULTS

	AC scalar (percent)	RC scalar (percent)
P&C NAIC RBC .....	-12.82	20.5
Bank Cap- ital .....	-.7	1.6

#### Scaling Based on a Sample of Companies in Both Regimes

Another scaling method would be to analyze a group of companies in both regimes. From a sample of companies in both regimes, it would be possible to run a regression to parameterize an equivalency line that represents the expected value in the common regime based on their information in the applicable regime.

Although analyzing a single group of companies under both regimes would provide a solid foundation for assuming equivalence theoretically, there are problems with this method under the stated criteria.

One issue is that calculating a given company's ratio under both regimes would likely not be appropriate because it would involve applying the regime outside of its intended domain. Applying the bank capital rules to insurers or the insurance capital rules to banks for calculating the scalar will not necessarily give comparable results. Although a result for a bank could be calculated under the insurance capital rules, this result may not really be comparable to insurers scoring similarly because their risk profiles differ. Indeed, the lack of a suitable regime for companies in both sectors is the primary reason the Board is proposing the BBA rather than applying one of the existing sectoral methodologies to the consolidated group.

Another disadvantage of this method is the difficulty of implementation. Companies typically do not calculate their results under multiple regimes. The limited available data, including the data from the Board's prior QIS, do not statistically represent the situations where a scalar is needed. Barriers to obtaining a representative sample of companies make this method very difficult to parameterize.<sup>27</sup>

<sup>27</sup> The limitations of this method may not apply in the international insurance context where the development of an appropriate international capital

Because of these problems, we do not recommend using this methodology as a basis for scaling under the proposal.

#### Scaling Based on Market-Derived PDs

The intuition of this method is similar to the historical probability of default method, but it would use market data to calibrate the relationship between solvency ratios and expected defaults. Market data can be used to calculate implied default probabilities with some additional assumptions. Credit default swap (CDS) prices or bond spreads depend heavily on default probabilities, and a Merton model can translate equity prices and volatilities into default probabilities.

Using market-derived default probabilities in place of historical data would have theoretical advantages over the recommended method. Because market signals are forward looking, this method could better capture changes in regimes. It might also be better able to address issues with past government support if the market no longer perceives institutions as likely to be rescued.

Although theoretically appealing, the data limitations prevent this method from being used. Bonds are heterogeneous and not frequently traded; equity prices are difficult to translate into default probabilities. Even in the largest markets where CDS data exists, only on a handful of companies have CDS information, and these companies

standard for insurance companies might make it possible to benchmark various insurance regimes.



are not necessarily representative of the broader market. For US insurance, an additional issue is that regulatory ratios are not available at the holding company level and market data are unavailable at the operating company level.<sup>28</sup>

We attempted to parameterize the scalar for the U.S. market using CDS data from Bloomberg and simple assumptions on recovery rates, but were unable to produce sensible results. Although the historical data show a strong relationship between capital levels and default probabilities, the strong relationship did not hold in our CDS analysis.

Several data restrictions might explain this issue. Only a small number of issuers have observable credit default spreads. Additionally, these are generally at the holding company level, which necessitated making assumptions for insurers as no group solvency ratio exists. Additionally, only relatively well-capitalized banking organizations appear to have CDSs traded currently, potentially creating a selection bias. The historical PD data demonstrates that beyond a certain point, capital does not strongly affect default probability.

Other potential explanations of this result exist. Changes in risk aversion and liquidity premiums across the panel period could also explain the results. Time-fixed effects were included in

some specifications of the regressions, but they did not improve the outcome of this method. Endogeneity between banks' held capital and their stress testing results may also contribute to the lack of sensible results. Because of the lack of sensible results, we do not recommend using this method to set the scalars.

#### *Scaling Based on Regime Methodology Analysis*

Another method would be to try to derive the appropriate scalars from a bottom-up analysis of the regimes, including the factors applied to specific risks and the components of available capital. Unfortunately, the differences between the regimes can be inventoried, but such an inventory cannot theoretically or practically be turned into a scaling methodology. In each regime, the risks captured are tailored to those present in the sector. The insurance methodology has complex rules around the calculation of natural catastrophe losses, and the bank regime has complex rules that apply for institutions that have significant market-making operations. Deriving an appropriate scaling methodology from the bottom up based on these differences would require quantifying each of them and then weighting to these differences to calculate an average. This calculation would be infeasible between banking and insurance regimes given the number of differences. Additionally, there are theoretical problems with trying to derive a weighting methodology from the differences that appropriately reflects the risk profiles of both banks and insurers.

#### **Conclusion**

This white paper describes our attempt to identify and evaluate different scaling methodologies. We find the PD approach based on historical data could be used to translate information between regimes in a way that preserves the economic meaning of solvency ratios. This method, however, requires data that are not currently available for some regimes outside of the United States. The election of the scaling approach is therefore a choice between using a single simple approach to scaling in all economies or differentiating the scaling approach by country and using the historical PD domestically. We recommend the latter. Although this approach will involve more work and some uncertainty for companies operating in countries with limited data, it should allow for scaling that is more accurate and aid comparability.

Scalars for non-U.S. regimes are not specified in the proposed rule given the Board's supervisory population. These may be set through individual rulemakings as needed. For the scalar between Regulation Q and NAIC RBC, the Board's proposal relies on the historical probability of default method.

We believe that the historical PD method derived in this paper will produce the most faithful translation of financial information between the U.S. banking and insurance regimes. Historical insolvency rates are currently the most credible economic benchmark to assess regimes against, and the long track record and excellent data on both the insurance and the bank U.S. regimes make this analysis feasible.

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<sup>28</sup> Although in some cases a sum of the capital of subsidiaries may be a reasonable proxy for the capital of the group, this approach would not be true for many entities including those with large foreign operations or using affiliated reinsurance transactions (captives). Only a handful of companies have reasonable proxies available for both NAIC RBC and the market-implied default rate of the company.

## Appendix 1: Graphical Interpretation of Scaling Parameters

### Derivation

We assume that there is some linear transformation between solvency ratios in different regimes, which we decompose into AC and RC to facilitate aggregation.

$$\alpha + \beta * \frac{AC_{\text{common}}}{RC_{\text{common}}} = \frac{AC_{\text{applicable}}}{RC_{\text{applicable}}}$$

Solving for the ratio in the common regime and then rewriting:

$$\begin{aligned} \frac{AC_{\text{common}}}{RC_{\text{common}}} &= \left( \frac{AC_{\text{applicable}}}{RC_{\text{applicable}}} - \alpha \right) * \frac{1}{\beta} \\ \frac{AC_{\text{common}}}{RC_{\text{common}}} &= \frac{AC_{\text{applicable}} - \alpha * RC_{\text{applicable}}}{\beta * RC_{\text{applicable}}} \end{aligned}$$

If the denominators and numerators are equal then:

$$\begin{aligned} RC_{\text{common}} &= \beta * RC_{\text{applicable}} \\ AC_{\text{common}} &= AC_{\text{applicable}} - \alpha * RC_{\text{applicable}} \end{aligned}$$

Using the equations for  $S_{RC}$  and  $S_{AC}$ :

$$\begin{aligned} S_{RC} &= \beta \\ S_{AC} &= -\alpha \end{aligned}$$

## Appendix 2: Derivation of the Historical Probability of Default

### Formulas

Using a logistic regression, the probability of a company defaulting can be expressed as

$p(d) = \frac{1}{e^{a+b*\frac{AC}{RC}}}$  where  $a$  and  $b$  are fit with the regression,  $AC$  is available capital and  $RC$  is required capital.

Setting the two default probabilities equal to each other to preserve this relationship when scaling produces:

$$\frac{1}{e^{a_{applicable}+b_{applicable}*\frac{AC_{applicable}}{RC_{applicable}}}} = p(d) = \frac{1}{e^{a_{common}+b_{common}*\frac{AC_{common}}{RC_{common}}}}$$

These equations can then be simplified to allow calculation of the scaled solvency ratio.

$$a_{applicable} + b_{applicable} * \frac{AC_{applicable}}{RC_{applicable}} = a_{common} + b_{common} * \frac{AC_{common}}{RC_{common}}$$

$$b_{applicable} * \frac{AC_{applicable}}{RC_{applicable}} = a_{common} - a_{applicable} + b_{common} * \frac{AC_{common}}{RC_{common}}$$

$$\frac{AC_{applicable}}{RC_{applicable}} = \frac{a_{common} - a_{applicable}}{b_{applicable}} + \frac{b_{common}}{b_{applicable}} * \frac{AC_{common}}{RC_{common}}$$

Using the graphical-interpretation formulas in the prior annex, the scalars are:

$$\mathbb{S}_{AC} = -\frac{a_{common} - a_{applicable}}{b_{applicable}} = \frac{a_{applicable} - a_{common}}{b_{applicable}}$$

$$\mathbb{S}_{RC} = \frac{b_{common}}{b_{applicable}}$$

### Table A.1. Summary statistics on insurers and banks

	All Firms							Baseline Assumptions						
	mean	sd	p5	p25	p50	p75	p95	mean	sd	p5	p25	p50	p75	p95
Total Assets	410,000	2,100,000	20,000	56,000	120,000	270,000	1,200,000	460,000	2,300,000	26,000	69,000	140,000	310,000	1,400,000
Risk Weighted Assets	290,000	1,700,000	11,000	35,000	79,000	180,000	820,000	340,000	1,900,000	18,000	47,000	99,000	220,000	1,000,000
RWA Ratio	22%	133%	10%	12%	15%	20%	37%	14%	3%	10%	12%	14%	16%	19%
Bank Observations	122,147							92,215						
Net Admitted Assets	1,800,000	11,000,000	2,800	14,000	56,000	300,000	4,900,000	3,000,000	16,000,000	7,300	35,000	150,000	710,000	11,000,000
ACLI RBC Ratio	69365%	6700000%	276%	575%	971%	2491%	37816%	728%	324%	262%	477%	690%	952%	1332%
Insurance Observations	54,663							27,893						

ollar Figures are in Thousands

## Appendix 4: Derivation of Accounting Analysis Scaling

### Formulas

Using a logarithmic regression between a company's income relative to their required capital yields the following formulas:

$$\frac{Income}{RC} = a + b * \ln(probability)$$

$$Prob (Income < r) = e^{\frac{r-a}{b}}$$

Setting the probabilities of loss (negative income) greater than the solvency ratio equal under the regimes yields:

$$e^{\frac{-r_{common}-a_{common}}{b_{common}}} = e^{\frac{-r_{applicable}-a_{applicable}}{b_{applicable}}}$$

Solving for the solvency ratio in the applicable regime:

$$\frac{-r_{applicable} - a_{applicable}}{b_{applicable}} = \frac{-r_{common} - a_{common}}{b_{common}}$$

$$\frac{r_{applicable} + a_{applicable}}{b_{applicable}} = \frac{r_{common} + a_{common}}{b_{common}}$$

$$r_{applicable} + a_{applicable} = \frac{r_{common} + a_{common}}{b_{common}} * b_{applicable}$$

$$r_{applicable} = \frac{r_{common} + a_{common}}{b_{common}} * b_{applicable} - a_{applicable}$$

$$r_{applicable} = \frac{b_{applicable}}{b_{common}} * r_{common} + (a_{common} * \frac{b_{applicable}}{b_{common}} - a_{applicable})$$

Using the formulas related to the graphical interpretation of the scaling formula, these formulas become

$$\mathbb{S}_{AC} = (a_{applicable} - a_{common} * \frac{b_{applicable}}{b_{common}})$$

$$\mathbb{S}_{RC} = \frac{b_{applicable}}{b_{common}}$$

By order of the Board of Governors of the  
Federal Reserve System, October 2, 2019.

**Ann Misback,**

Secretary of the Board.

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